

A FIRST BOOK OF ECONOMICS



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A
FIRST BOOK OF ECONOMICS

BY
NORMAN CRUMP



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PREFACE

THIS book represents an attempt to explain, in brief though general terms, how things work in the business and financial world. The reader will find in it comparatively little pure economic theory, nor will he learn from it how to conduct himself or succeed in his particular business or profession. What I have aimed at is to give the reader on the one hand an inkling of what economic theory is concerned with, and to enable him on the other hand to understand a debate in Parliament on an economic question or the City columns or business news in a newspaper of repute. In short, this book seeks to explore the border-line between economic theory and practice, so that to whichever side of this line the reader subsequently travels, he may find his work made a little easier.

To avoid any misunderstanding, may I say that this book is based mainly on experience of the City and its ways. Thus, as he has been warned, the reader will find little formal teaching or rigid doctrine, but rather a discussion from an economic and, I hope, impartial standpoint of some of the many questions and lessons of the post-war period, together with a description of the machinery of business and finance. Many references are made to contemporary events, but as the book was written in 1928 and 1929, the reader may find that, in these depressed days of 1930, some of the examples seem a little out-of-date. Here and there footnotes have been inserted while the book was passing through the press. I may add that my main regret is that the book was already in the printer's hands when the Bank for International Settlements

was founded. I look upon the inauguration of that institution as one of the most important events in the economic history of the world, and as affording the opportunity for solving some of the most pressing of the world's financial problems.

My thanks are due to my secretary, Miss B. S. Townsend, for carrying out the arduous task of reading the proofs. The responsibility for any errors is mine alone. May I also add a tribute to the memory of the late Mr. Walter Leaf, to whose example and teaching during a period of four years I indeed owe much.

NORMAN CRUMP.

July 29, 1930.

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CHAPTER I

Introduction—The primary rules of economic life.

A TEXTBOOK upon Economics should properly begin with a definition of the term. This in the rigid sense I do not propose to give. Most people know what an "economic question" is, and in a book of this kind which is intended to be illustrative rather than strict, it seems sufficient to let it go at that. It may be said that economics is the meeting-point of mathematics, ethics, law and psychology. Certainly, a knowledge of mathematics, though not essential, smooths the path of the student. As regards psychology, economics and human nature are inextricably intermingled, while in so far as ethics are concerned, if this book does not make the reader realise that there is room for a man's conscience even in the whirl of politics or finance or commerce, it will have failed in one of its main purposes.

If I had to give a definition of economics, I should call it the science of "human wants", such wants being for the purpose of the definition mainly material. It is concerned with how they arise, how they are satisfied, and above all, with the question how each one of us manages to persuade the rest of the world to provide him with food and drink and clothing and everything else he needs. O. Henry tells an amusing story of one of his countrymen who arrived at a South American port with a cargo of shoes, only to find that the people of the country never wore them. He consulted a friend who said, "It is no use trying to create a demand; what you need is a necessity to make the demand". So

in pursuance of the theory he wired home for a cargo of prickly cockleburrs, and on their arrival went out in the middle of the night and sowed the streets with them. By the end of the following day, naked feet had gone out of fashion, and the cargo of shoes had been sold out.

We can now take the next question : what are our wants?

Firstly, I should say land, air and water. We must have land to stand on, air to breathe and water to drink and to wash in. Next, I should add food, only qualifying this by saying it must be adequate, wholesome and nourishing. Then comes clothing, and here all that is absolutely necessary is that it should be sufficient to keep us warm and to comply with such regulations as we all agree are necessary to avoid scandal. Next comes a roof over our heads to protect us from the sun, wind and rain, and finally a fire to keep us warm and to cook our food. These are the bare, absolute necessities of life, and if anyone thinks that by themselves they are insufficient, well, if he served in the war, let him recall the day when he was glad if he could get all of them as he needed them.

Now as every textbook upon economics tells us in the first chapter, in the old days when mankind lived in savage tribes, each man had to get all these necessities for himself and for his wife and children. It was a risky, wearisome job to catch one's own dinner, and no wonder primitive man often went hungry, and seldom had time to provide himself with luxuries. As time went on, he gradually learned several lessons. The first probably was, "Never do for yourself what you can persuade someone else to do for you". The second was, "There is only one way to persuade the other fellow to do something for you, and that is to do something else for him". The third was, "A man can learn to do one job really well in less time than it takes him to learn to do two jobs badly". The fourth was a much longer lesson: it ran, "If each man sticks to his own job, and works at it not only to make what he requires himself, but also to make what his

neighbours require, and if all then proceed to exchange their surplus production for what each needs of the other fellow's production, then everyone at the end of the day will have far more than if each worked just for himself". The fifth was very important: it ran, "A man can spend his whole time in making what others require, and none on making what he himself requires, and by exchanging the whole of his production can get for himself far more than if he produced directly for his own needs". The sixth was, "When it comes to a swap, it is up to each man to make as good a bargain as he can, but let him make it in such a way that he can look himself in the face after he has done it".

These six lessons were not learned all at once. They have taken thousands of years to learn, and even to-day some people have not learned them all. As the tribe of hunters developed into the tribe of farmers, and then into the nation of manufacturers, and so into the complex organism of producers, distributors, merchants, shippers, bankers and so on, so were these lessons gradually driven home. Take the case of the shirt that the reader is, I hope, wearing as he reads this book. The cotton was grown in Kentucky, shipped from New Orleans to Liverpool, spun and woven in Manchester, and made into a shirt in London. The linen thread was spun in Belfast from flax grown in Esthonia, and the buttons came from Japan. The men who grew the cotton and flax, who spun the yarn and wove the cloth, who made the shirt, and who, last but not least, moved the materials from one country to another, from one town to another, until finally it was done up in a brown-paper parcel and handed to you over the counter, all were unconsciously carrying out these laws. Whether you believe in Free Trade or Protection, Individualism, Socialism, Communism or any other "ism", these laws still hold good. The remainder of this book is concerned with the way these laws operate in practice, and the exact way in which they govern and are expressed in the complex organism of industry, commerce

and finance that the world to-day has developed. The business world has its own methods and its own ways of explaining things. We shall gradually see exactly what each term means, and perhaps occasionally see that a certain term means nothing at all.

CHAPTER II

The five divisions of commerce and industry—Extraction—Production—Distribution—Consumption—Lubrication—The governing factor of exchange.

THE case of the shirt, very briefly touched upon in the previous chapter, will serve as an example of the four main stages of the industrial and commercial machine. These are—

EXTRACTION
PRODUCTION

DISTRIBUTION
CONSUMPTION

There is also a fifth division, namely, LUBRICATION, or in plainer English, the oiling system of the machine.

The name given to the first stage, namely, "extraction", is properly only applied to minerals. The process consists of the winning or extracting of the coal or the iron ore from the earth. So soon as the coal is brought to the surface, the process is complete.

How far can it be applied to animal and vegetable products? No one can "produce" or manufacture a sheep or a grain of corn, though with the advance of chemical knowledge there may already be some who consider a synthetic sheep as not being beyond the bounds of possibility. Again, is the breeding and rearing of sheep, or the sowing and cultivation of corn sufficiently akin to the mining of coal and ore to warrant us including these processes all under the same heading of extraction? The decision must largely be an arbitrary one, on which the reader may well have his own views. Still, in many ways it is convenient to class as

allied processes the mining of coal, the rearing of sheep and the growing of corn, and to say that the first stage is complete when the coal reaches the surface, the sheep is led to the slaughterhouse or to the shearingfold, and the corn falls to the scythe.

Even this decision leaves out several well-known possibilities. What of the dairy cow, and the corn used for seed? The industrial machine must take heed of the fact that nature is reproductive, and make provision therefor. And on the other side, the attempt to divide the whole of our life into rigid watertight compartments will inevitably and rightly only meet with partial success.

The next stage is that of "production". It begins where the "extraction" stage ends off. It embraces all processes of manufacture, right down to the completion of the product in the shape desired by its ultimate user or consumer.

As we have seen, it is difficult to differentiate it from extraction at the one end; it is equally difficult to differentiate it from distribution, and indeed it can be argued with some force that production and distribution are part and parcel of the same continuous process designed to bridge the gap between extraction and consumption. Production, too, falls into many stages, and in many cases the consumer of one product is himself the producer of another. Thus the steel producer would consider that the production of steel was complete when that steel reached its final form, a joist or girder, and that the consumer of steel was the man who bought that joist or girder in its final form. Yet the purchaser of that joist may require it for incorporation in a factory or workshop which he himself is engaged to complete. From his standpoint the steel girder is part of his raw material. He is a producer of factories and to him the consumer is the company who has placed the contract for a factory. Even now the process is not complete. For example, the consuming company may have had that factory built for the purpose of making biscuits. From their stand-

point the factory is simply part of their equipment to enable them to produce biscuits, and so it is possible to argue that this chain which started with the iron ore extracted from the earth has ended in the biscuit which we find upon our breakfast table. The important point to realise at this stage is that production is a highly complicated process and that it is extremely difficult to say where it begins and where it ends. The attempt to classify commodities under headings of raw materials and finished articles is nine times out of ten doomed to failure, for the simple reason that the finished article of one producer is the raw material of another. In separating production from the other main stages of the industrial commercial machine, a certain amount of progress towards the analysis of that machine has been made, but the progress is extremely limited in degree.

Distribution consists of the transfer of commodities from the place where they first came into existence to the place where they are required for use. Thus distribution includes all forms of transport. It includes, however, much more than this. The whole of the complicated system of marketing falls under the heading of distribution, from the world market in raw material such as cotton and wool to the multiple store and the village shop. It is often urged, especially by producers, that distributors are not performing a wholly useful function in our economic life. The reply to that is that while in some cases the channels of distribution may be unduly complicated and depend upon an excessive number of operators, yet a ton of coal at the pit head or a steel girder fresh from the rolling-mill in the north of England is no use, so long as it remains there, to the would-be consumer who lives in London. Furthermore, the consumer has neither the time nor the knowledge to deal directly with the producer and all his manifold needs. The function of a distributor, whether he be the transport agency or the merchant, is to bridge the inevitable gap between producer and consumer.

The next stage is that of consumption, and enough has already been said to make it clear that it is just as difficult to define the consumer as it has proved to define the producer. Fundamentally and generally the two are identical; for, as we saw in the first chapter, "There is only one way to persuade the other fellow to do something for you, and that is to do something else for him". When something is done for you by the other fellow, then you become the consumer; when you do something else for him, you are the producer. But even apart from this fundamental truth we have seen that the producer himself is usually the consumer of raw material, and this is especially true in modern economic life when one individual conducts one stage of a manufacturing process, and passes on his product to the next individual who conducts the following stage.

Attempts are made occasionally to advance the rival claims of the producer and the consumer. A fair comment would be the following. We are all consumers, because otherwise we would starve. We are most of us producers, because it is only by producing goods ourselves that we can obtain the necessities we consume. Even this statement needs the following qualifications. We are all of us consumers all the time because life is a continuous process needing continuous maintenance. We are not most of us producers all the time, because it is possible to produce during one period more than the world requires of us, and so we can remain idle for a period without forfeiting our right to continue to be a consumer. Much more will be said on this time element later on in the book. On it rests, for example, the whole question of the claims of capital to an annual return. It throws into relief the serious problems created by unemployment, and in general it helps us to answer the ethical question of how far an individual is entitled to be supported by the community when he either cannot or will not contribute his quota to the community's needs.

The fifth division, namely lubrication, embraces all those

who, while they are necessarily consumers, are not engaged in extractive, productive or distributive work. Their function is to go round with the oil-can, and to maintain the commercial machine in smooth operation while not taking any definite share therein. Many examples of this may be quoted. The whole business of money, banking and finance, is one side of the lubrication division. The collection and publication of information, ranging from the advertising expert and the journalist to the writer and author, is another. All those engaged in maintaining law and order and the government of the state form another branch, for without organised government, a code of law and judges to enforce that law, the commercial machine must inevitably break down. In general, it is a wise rule that when the question arises as to whether any class of individuals is performing a necessary service to the community, it should first be enquired whether or not they are part of the lubrication system.

This chapter is designed to lay down the broad divisions of the commercial machine, and to help the reader to decide to which division a given profession or trade should be allocated. It makes no attempt to answer the questions put forward in the first chapter nor, in fact, to show how the various parts of the machine are connected together and how each one drives the others. Before proceeding to the next chapter the reader is invited to think out for himself the fundamental question as to how far the economic machine, and indeed our daily life, is dependent on the exchange of the goods we produce and the services we perform for the goods and services we need from others.

CHAPTER III

The reasons for exchange—The example of the bricklayer—The need for a means and medium of exchange.

IN order to answer the question propounded at the end of the preceding chapter, it is necessary to become a bit more definite. We have already defined what are the common needs of mankind—food, clothing, housing, fuel, light and air. The reader will by now have decided for himself that he and everyone else under the modern economic system normally obtains these necessities in exchange for the goods he produces and the services he renders. Now let us take the simple case of a bricklayer. He is a producer of houses. The house is a necessity of life, a necessity to him just as much as it is to his fellows. But he does not simply lay enough bricks to build his own house and then stop there; he goes on laying bricks and building houses for others in the whole of his working hours. He has to do more than this. He has to persuade the community as a whole, for whom he is devoting his whole life to building houses, to provide him in return with his food, clothing and all the other things besides houses that he needs to make his life possible and tolerable. Now theoretically, in a very simple state of society, he could go to the farmer and say, "I will build you a house if you will provide me with my milk, my meat, my bread and my vegetables". He could go to the weaver and say, "I will build you a house if you will provide me with clothing". He could go to the coal-miner and say, "I will build you a

house if you will provide me with fuel", and so on with everybody who produces the necessities which the brick-layer needs. In practice, such a course of action is impossible. For one thing, he obviously could not build houses for all these people at once. While he was building the house for the farmer he would freeze for lack of clothing and fuel. Again, it is a waste of his time to have to go wandering around the country, searching not for any farmer or weaver or coal-miner, but for the particular farmer, weaver or coal-miner who was in need of a house. Finally, even if he could come across a coal-miner in need of a house, they would have to agree upon the proper equivalent between the house the miner would get and the number of sacks of coal he would supply.

These obstacles are clearly fatal to any process of direct exchange, so that even when we are able to recognise that our whole life depends upon this fundamental principle of exchange we have yet to learn how to put it into practice. In order to translate theory into practice, three things are needed. Comprehension of the principle of exchange, the provision of a means of exchange, and the provision of a medium of exchange. The first is clearly theoretical, and the other two are equally clearly more practical. To explain exactly what is meant by this, the first concerns the basis of supply and demand, the next is a matter of markets and the third a matter of money.

Were the first to be considered now the reader would find himself in some danger of being lost in a mist of theory. It is more convenient to defer the consideration of supply and demand for the moment, and to make this broad observation: that in the case under review, the more bricklayers there are building houses, the fewer sacks of coal will each get for his house. Conversely, the more coal-miners there are in need of a house, the more sacks of coal will each have to give in exchange for his house. Every increase in the amount of coal a miner is prepared to give for his house will

stimulate new people to learn how to build houses. There is a direct relation between the number of people wanting to build houses, the number of people in need of houses, and the amount of other goods and services which are obtained by the bricklayer for each house.

CHAPTER IV

The means of exchange—Definition of a market—Produce markets—
Closed markets and their justification—Local markets—Shops—
Other means of exchange—The machinery of buying and selling—
The merchant.

THE present chapter is concerned with the means of exchange, and here the reader is warned that he is leaving the introductory section of the book, which is mainly theoretical, and will be faced with more practical considerations and the description of how the various parts of the commercial and economic machines actually work. The perfect market was defined by Professor Marshall as being "a district, large or small, in which there are many buyers and many sellers all so keenly on the alert and so well acquainted with one another's affairs that the price of a commodity is always practically the same throughout the whole of the district". This definition clearly represents an ideal, and it is pertinent to add that, as the reader himself probably knows, it is possible to find two shops within a mile of each other where prices are by no means the same. In its broadest sense markets, or rather the process of marketing, includes the whole mechanism of buying and selling and everyone who is engaged therein.

Among various types of markets may be mentioned the following :—

(a) *Produce Markets*.—By these are meant the special markets formed to deal either in a particular commodity or a particular group of commodities. Thus raw cotton im-

ported into England is bought and sold on the Liverpool Cotton Exchange. Raw wool is dealt with on the London Wool Exchange. Grain is dealt in partly on the Baltic Exchange, partly on the Mark Lane Corn Exchange, partly at Liverpool and, of course, partly at the general country markets which do not fall under this heading at all. Among others, London contains the Covent Garden vegetable market, the London Coal Exchange, the London Hop Exchange, the London Iron and Steel Exchange, Smithfield Meat Market and many other markets besides, even down to the Caledonian Market which is reputed, though probably erroneously, to deal partly in other people's property! The best example, perhaps, of a market dealing in a group of allied commodities is the London Commercial Exchange in Mincing Lane. It deals in tea, coffee, rubber, spices, fibres and a whole host of foreign, mainly Eastern, produce. Another example is the London Metal Exchange dealing in tin, copper, lead and spelter.

Now all these markets have certain features in common. One has already been mentioned, namely, that each one deals in a particular commodity or set of commodities. Another is that they are, most of them, closed markets, which means that it is not open to anybody to enter one of these markets to buy and sell, entry being limited to members. The object of this is not to restrict trade or to establish a monopoly for the members of the market, but to establish confidence. A member has to conform to certain conditions, to be of a certain standing and to give certain definite guarantees. The result is that everyone dealing on one of these markets knows that the man he is dealing with is able and willing to keep his engagements. This is of particular importance, because when business is active, deals are put through by word of mouth supported possibly by a hurried entry in the dealer's notebook, so that a general sense of confidence is the very foundation of this kind of business. Moreover, where all people dealing on a market

are bound by a common set of rules and by a common standard of conduct and tradition, and even by a common language and set of technical terms, it is possible to make business much more flexible and to carry through complicated transactions in a simple fashion. If these points are realised it will be seen that the existence of closed markets, even in stable and necessary commodities, facilitates and does not hinder trade, promotes and does not restrict the general level of material prosperity. It is but one more example of the rules laid down in the first chapter of this book.

(b) *Local Markets*.—In addition to the specialised produce markets many towns especially in agricultural centres have their own local markets dealing mainly in local agricultural produce. Here the right to deal is not definitely restricted to members, but is open to anybody who chooses to come along, though in practice only local interests will be represented. Nor is the market necessarily confined to any particular kind of produce, though it may be found that in certain towns the market may on one day be confined, for example, to live-stock. Of course, where a town is the centre of some particular industry, special produce exchanges are set up of the type described in the preceding section. Thus raw cotton is dealt with at Liverpool because Lancashire is the centre of the English cotton industry. Cardiff has its own coal exchange, and so have other towns situated in or near the coalfields. There are iron and steel Exchanges at Birmingham, Middlesbrough and elsewhere, besides the exchange at London previously mentioned. All these special exchanges would again be closed markets, open only to members.

(c) *Shops*.—In considering the various means of exchange, attention must not be confined solely to formal markets of the kind already described. Every shop represents a means of exchange, whether it is the small village general shop or the small suburban shop dealing in some particular kind of

goods, such as the butcher, the baker or candlestick-maker, or else the multiple shop or the big departmental store. The last two are a comparatively modern development, and yet in a sense are the antithesis of each other. The multiple shop is a group of shops in many cases spread over a large section of the country, all under common ownership and management and all dealing in the same commodities or kind of commodities. Thus there are several well-known companies operating multiple provision shops. The London catering trade is largely in the hands of multiple shops, and this rule applies whether you are seeking a good "pull-up for carmen" or a wedding breakfast. The departmental store, on the other hand, seeks to concentrate under one rule and under one ownership and management every kind of shop from a boot-maker to a florist.

In recent years a new phenomenon has shown signs of appearing, namely, the multiple departmental store which is best defined as being the common offspring of the two. This is carrying the advantages—or disadvantages—of common ownership and management to the extreme.

(d) Even after allowance is made for both markets and shops, there is a large volume of trade carried on independently of them all. In very many cases producer and consumer deal direct with each other. The means of exchange here is nothing more than an exchange of letters between them by which the terms of a particular sale are agreed. Thus an electric light company requiring a new generating plant will not go and buy it in the appropriate market which, indeed, does not exist, but will make it their business to know or to find out manufacturers of this plant and will send to some of them a statement of what is required, asking if they can manufacture and what price they will quote. The statement of the electric light company's needs, which in this case will be a highly technical document, is called a specification, and the manufacturer's offer together with his price is known as a tender. The electric light company, on examining the tenders

received, will see if they conform to the specification, will take into account the prices quoted, the reputation of the manufacturer and all other relevant considerations, and then will select one tender out of those submitted.

Again, the personal interview provides a means of exchange in a very large number of cases. Most manufacturers maintain a sales organisation responsible solely for selling their goods. This will include both an indoor and an outdoor staff. The indoor staff will deal with all offers made by letter or by callers at the Company's offices. The outdoor staff will consist of travellers, commonly known as commercial travellers, whose business it is to travel round the country looking up old customers of the firm and seeking out new. In some cases travellers will take samples with them, in others they can only take catalogues and specifications. It is clear, for example, that the manufacturer of locomotives or steam-boilers would find some difficulty in sending samples around with his travellers! Conversely, a manufacturer will maintain a buying department, whose business it is to buy all the materials that he may need. Here again the staff will be both indoor and outdoor, though as a rule it is customary for the prospective seller to travel the country and the prospective buyer to stay at home. Still, we must stress the fact that with modern competition the stay-at-home policy does not pay and that the buyer must be just as much on the alert as the seller. Furthermore, whether the manufacturer is concerned either in the buying or the selling, in cases where he is interested in a commodity dealt in on a special exchange, he may well have either members of his staff, or else accredited agents, elected as members of that particular produce exchange.

(e) A fifth and very important means of exchange is that of the big merchanting firms. A merchant, as a rule, does not engage in manufacture, but there are many cases of firms which both manufacture on their own account and also act as merchants. In certain trades the function of merchant

is very clearly defined. Thus the dry goods warehousemen and merchants congregating around St. Paul's Cathedral form a link between the textile manufacturers in the country and the tailors' and drapers' shops. Big shops may at times deal directly with the manufacturer, but the latter usually likes to sell his output in large units, amounting to thousands of yards at a time, while the small shop, of course, buys in small units. It is for this reason that the warehouseman in St. Paul's Churchyard, who is equipped with suitable space for storage, and financial facilities to enable him to buy in large lots instead of small, forms a necessary and vital link. There is, however, a growing tendency for manufacturer and shopkeeper to deal with each other direct, thereby eliminating the merchant, and at least one such firm has lately gone out of business. The merchant, too, plays a very prominent part in international trade. The foreign buyer, unacquainted, perhaps, with the names of one hundred and one British manufacturers of what he requires, naturally comes to the London merchant who can supply his needs from stocks purchased not only from British, but also from other foreign manufacturers. Again, it stands to reason that if a buyer approaches a merchant who draws his stock from several manufacturers, he stands a better chance of getting exactly what he requires. Thus the merchant gives him the advantage of a greater variety.

CHAPTER V

Methods and rules of exchange—Terms of purchase and sale—Grading of commodities—Definitions of place of delivery—Dealings in "spot" and "futures"—The justification of a futures market—The insurance element in futures.

IN addition to describing the various means of exchange, markets and so on, it is necessary to say something about their ways of doing business. Each market and each trade has its own customs, and the whole question is an extremely complicated and technical one, so no more can be attempted here than to lay down certain broad lines. These relate to matters such as the description of the commodity dealt in, the terms and time of delivery, and the terms and time of payment. It is essential that all these matters should either be determined in advance between buyer and seller, or else conform to the customs of the trade; that is, both buyer and seller alike must agree on exactly what they are dealing in, on how, when and where it is to be delivered and how and when payment is to be made.

So far as the description of the commodity is concerned, where this is of a complex nature such as a piece of machinery, locomotive or a motor-car, its exact nature will be defined either in the specification relating to that particular transaction or else in the seller's catalogue. Paradoxically enough, these cases are comparatively simple and need little further explanation. Difficulties arise more in the case of the simpler and more common commodities such as wheat, coal, cotton, wool, etc. These commodities are usually bought and sold in large quantities, and it is obviously impossible for the

buyer to inspect every single grain of corn he buys when perhaps he is buying a whole shipload. Definition is obtained jointly in two ways, namely, by grading and by sample. Thus Manitoba wheat is graded as Nos. 1, 2, 3, etc. Cotton is graded as fair, middling, low middling, etc. These definitions may sound vague, but they are based upon certain standard samples which are agreed upon in the trade once and for all, and the buyer of a consignment of wheat or cotton is entitled to take a representative sample therefrom and see whether it conforms to the standard sample of the grade which the seller is under contract to deliver. Also, if the buyer finds that the bulk of the cotton or grain delivered does not come up to sample, he is entitled to reject delivery, or to pay the lower price corresponding to the actual quality of the consignment, or even take such proceedings for breach of contract against the seller as the law of the country and the rules of the market permit.

So much for the description of the commodity dealt in. There remains the place and time of delivery. For example, wheat may be sold afloat, that is while it is still on board ship halfway across from Canada to England. In this case the buyer has to await its arrival, discharge it from the ship to the quayside, and in general dispose of it and pay all the expenses of unloading, etc. He may buy it "ex ship"; that is, lying in the ship at the docks, so that again the unloading is done at the buyer's expense. He may buy it "landed"; that is, the seller engages to discharge it from the ship on to the quayside, but the buyer has to bear the expense and trouble of removing it from the quayside to his warehouse. Two terms which very frequently occur in overseas trade are f.o.b. and c.i.f. f.o.b. means "Free on Board"; that is, if an exporter of goods sells them f.o.b. he, the exporter, undertakes to load them on to the ship, bearing all necessary expenses. The importer bears the freight from the port of origin to the port of destination. c.i.f. means Cost, Insurance, Freight. That is, the exporter who sells c.i.f.

agrees to bear the cost of shipping the goods across the ocean to the port of destination and of insuring them while on the water. Thus the c.i.f. price really means the price covering the original cost to the exporter plus the cost of insurance and freight. Similar questions arise with goods even when they do not have to cross the sea. Thus coal may be sold at the pit-head, *i.e.* the buyer has to take delivery at the pit-head and bear the cost of removing it to his own coal cellar. Complaints are occasionally heard that at a time when house coal is selling at about £2:10s. per ton, delivered at the householder's cellar, the same coal is only costing 25s. pit-head. Obviously, the answer is that if the householder is prepared to take several hundred tons and to go down to the Derbyshire coalfields to get it, he, too, can have it at the pit-head coal price! Steel girders, machinery, etc., are often quoted either "ex works" or "delivered (d/d) works". "Ex works" means the buyer takes the goods over at the maker's works and bears the cost of transport, while "d/d works" means that the seller engages to deliver the goods at the buyer's works. It is obvious from the foregoing that these terms of delivery have a direct bearing upon the price quoted. The c.i.f. price will always be bigger than the f.o.b. price, and, in general, when a buyer and seller agree on a price between them, the terms of delivery are taken into consideration.

This introduces the new element of "future" and "spot" dealings. A broad definition is that a "spot" transaction means that the goods must be delivered and the money paid on the spot, *i.e.* at the time the transaction is made. The "future" transaction means that delivery takes place not at once, but at a future date of delivery according to the custom of the market. Thus raw cotton in November is often bought and sold for March delivery, and the market report for a given day in November will give not only the spot price, but also the futures price for December, January, February, etc., delivery. Furthermore, different prices will

be given for the various grades, "middling" being the basis.

The fundamental object of a "futures market" is as follows:—Manufacturers, merchants and, indeed, business men generally have to lay their plans ahead and have to make decisions one day which may not begin to operate for several months ahead. For example, the cotton-spinner must always keep a certain stock of raw cotton in hand, or else he may, one fine day, book a new and big order for yarn, only to find himself short of raw cotton. Also he knows that prices vary from day to day, up and down, and he may decide on one day that prices are as low as they are likely to be and that it would pay him to buy ahead for his future needs. On the other hand, he may not have room in his own factory to store all the cotton he may need for several months to come, while conceivably the cotton he wants to buy may not even have been picked or, indeed, have reached maturity in the cotton-fields of America. But if he can buy cotton for delivery in, say, three months' time at a price he knows at the time he decides to buy, then he can lay his plans ahead. Similarly, the cotton-grower may want to sell his cotton before harvest time, either because he needs the cash or because he thinks prices are going to fall. Here again he, too, takes advantage of the future market and sells his cotton for delivery in three or four months' time. Of course, many operators in the cotton and other markets may, for example, buy cotton three months ahead and when two months have elapsed find that prices have improved, and that it pays them to sell the same amount of cotton they have purchased for delivery at the same date, *i.e.* one month ahead. In some markets people buy and sell "futures" without the smallest intention of either taking up the goods or, conversely, the ability to deliver them. In other words, they are speculators pure and simple, for when they buy a future they mean to sell it again at some future date before the date of delivery.

That is why many people attack dealings in futures as a form of speculation, and of course if the system is abused such an attack is justified. On the other hand, it can be a very real form of insurance. Take the following case. The cotton spinner is producing yarn for stock. He knows he will not be able to sell that yarn for three months. He knows that the selling price of yarn varies roughly with the selling price of raw cotton, and he knows that his chance of profit or loss on the production of that particular lot of yarn depends (a) on the price he pays for raw cotton now, and (b) on the price he will get for his yarn in three months' time. If cotton slumps in the meantime, he will obviously make a loss. If cotton rises he will of course make a profit, and a bigger profit than he originally set out to make when he put the work in hand. So what he does is this. When he buys his cotton on the spot which he needs for this yarn, he at the same time sells cotton futures for delivery three months ahead. This covers him. If the price of cotton falls during these three months, when the time is up he can buy up spot cotton cheap for delivery against the future which he has sold at a high price. Thus he makes a profit on his future deal commensurate with the loss he has actually incurred upon his yarn. Of course, if cotton rises, his future deal will involve him in a loss, but on the other hand he will make an extra profit on his yarn which he neither expected nor planned to make, so once again he cancels his loss. It is in ways such as these that futures dealings have proved a real form of insurance, even in the case cited above, when the cotton spinner sells his future at a time when he does not possess the cotton to deliver against it. Such a form of insurance is known as "hedge selling". Even the speculator, the man who comes into future markets purely to gamble with cotton he neither wants nor can deliver, performs in a sense a useful function, simply because the more people there are in the market, the easier it is to deal. Without the existence of a speculative element the cotton spinner might

be unable to sell his future. Of course the speculative element can at times become a nuisance, and certain markets—for example, the Liverpool Cotton Exchange—take steps to ensure that all operators are *bona fide*. It is absolutely essential that his fellows should feel confidence in an operator, that he will fulfil his obligations; otherwise the whole system at once breaks down.

This completes the broad survey of the markets. It only remains to add that special markets, such as the Money Market, the Foreign Exchange Market and the Stock Market are dealt with in subsequent chapters.

CHAPTER VI

Money—Its object and use—Necessary qualities—The precious metals—
Legal tender—Paper money—Bank-notes—Bills of exchange—
Cheques.

THE object of money is to provide a medium of exchange, *i.e.* it must possess such qualities that if any seller consents to accept money in exchange for the goods he supplies, he must know that when he in his turn goes to buy the goods he needs, he will be able to hand over the same money in exchange for them. Money by itself is of no particular use to us. For example, we cannot eat it, we cannot wear it, it will not house us or keep us warm. Its sole use to us is that we can exchange it for the things we need, and it is because we have that knowledge and confidence that we consent to accept it for the goods we make and supply. Even gold by itself is of no use to us. The seller on a desert island who has discovered a sackful of sovereigns will cheerfully part with the lot for a drink of water. The sole reason why we want money and try to get as much as we can is because we know that we can exchange it as and when we like for the things we really need.

Money overcomes the place difficulty. Thus money we have earned or acquired in London, we can spend in Liverpool or Glasgow. It also overcomes the time element. Money we have received on Tuesday, we can spend on Thursday or next month or next year. Reverting to a previous chapter where the difficulties of a bricklayer were described, it will be seen that if he can sell his house for money, he can use part

of that money one day and in one shop to buy his milk, another part to buy his meat and a third part to buy his bread, and so on throughout the whole scale of his needs.

For money to fulfil its function it must have certain definite qualities which in modern society are defined by law. The reason for this will be made clear by reverting to a simple, primitive example, namely, the fact that certain tribes, many centuries ago,* used the cow as their unit of money, *i.e.* as their medium of exchange. Let us see some of the objections to cows as a medium of exchange.

(1) *Uniformity*.—It is obvious that one piece of money ought to be as good as the next; cows are far from uniform.

(2) *Portability*.—As money is spent at all sorts of times, and carried about from one place to another, it is obvious that it must be portable. The cow would be an awkward kind of currency to take shopping in the West End!

(3) *Durability*.—As money is not necessarily spent at once, it is obvious that it must not deteriorate. All cows in time turn into beef.

(4) *Divisibility*.—The cow would be an awkward unit of money if it should happen that the shopper desired change.

(5) The next idea is rather difficult to explain. It is shown subsequently that the whole economic structure is immediately upset if money can be produced and multiplied indefinitely. It would be pleasing for the householder to find one morning that instead of having one cow he had a cow and a calf, but if, as is inevitable, many householders found themselves simultaneously in the same fortunate position, they would all have equally discovered that the whole scale of prices had been upset as a direct result of the multiplication of the community's stock of money. This point will be discussed at some length in further chapters. Meanwhile it is necessary to add that money should possess a fifth quality,

* And apparently in some parts of Africa to-day.

namely, that it should be possible to control the total amount in existence.

It is because they possess these qualities that from early days precious metals such as gold and silver have been employed as money. These metals are comparatively scarce, so that the last quality is fulfilled. They can be struck into coins which are portable, free from deterioration and are divisible, because coins of various sizes, containing various quantities of gold and silver, can be struck to meet the requirements of the community. Above all, a gold or silver coin can be and is defined by the law of the land. It must contain a definite weight of gold or silver and be of definite purity. It must bear on it the seal of the community—for example, the King's head. It may be milled round the edge, so as to stop unscrupulous people chipping bits from the outside, and so acquiring gold and silver for nothing. Finally, the law lays down that gold and silver coins may be struck only under the control of the Government, and that any private person striking coins on his own account is subject to penalty. This last provision is necessary for two reasons. Firstly, the average person cannot easily test the purity of every coin he receives, but so long as he knows that every coin came originally from the Mint, he has confidence in the amount of gold or silver it contains. Secondly, if the Mint alone is allowed to strike coins, the Government can keep control over the amount of money in circulation. This second point is of comparatively minor importance. For one thing, the main check over the amount of money in circulation rises from the comparative security of gold and silver. For another thing, if the private citizen is deterred by law from striking coins on his own account it is only fair to give him the power to take gold and silver to the Mint and demand that the Mint shall coin for him his gold and silver, and return to him a corresponding amount of money less, perhaps, a sum (called seignorage) for the trouble and expense of coining it.

So far we have dealt with money in the form of coin, but

there is no need to emphasise the fact that the bulk of money in use to-day consists not of coin, but of what for the moment we will describe as "scraps of paper". Before going further, however, it is necessary to lay down one broad definition, and that is what is meant by legal tender. Just as the law stepped in and said that the private citizen could not mint money, so equally the law comes in and says that certain kinds of money either are, or are not, legal tender. By legal tender the law means that anyone owing money to anybody else, can discharge his debt by offering any form of legal tender money and the creditor is bound to accept such money in payment. In England, gold coins are legal tender to any amount. Silver coins are legal tender up to a limit of 40s. Copper coins are legal tender up to a limit of 13d. No creditor is bound to give and no debtor is bound to receive change. As regards paper money, Bank of England notes are legal tender for any amount. Bills of exchange, cheques and all other kinds of legal paper money (using money in its broadest sense as a medium of exchange) are not legal tender money at all, *i.e.* no creditor can be forced to accept a cheque, whether it is drawn on the Bank of England or on the Bank of Hope and Expectation.

Bank-notes.—The operations of the banking system are considered in a subsequent chapter. Meanwhile, a bank-note can be defined as a written promise by a banker to pay a given sum in legal tender money on demand by the bearer of that note. The origin of the bank-note is very simple. There are many objections to a private citizen keeping a stock of gold in his own house, and these objections ruled even when burglary was a capital offence; so he used to hand the gold over to his banker for safe keeping, and the banker would naturally give him a receipt for the amount of gold thus handed over. The first of these receipts would naturally say "Received of Mr. John Smith the sum of £100 in gold". Mr. John Smith would have to present that note to his banker in order to get his gold back again. At a very early

date these receipts took the form "Received of bearer £100 in gold", from which they came to say, "I promise to pay bearer on demand £100 in gold". They then became what has since become known as a bank-note.

Now, so long as a banker's name was well known and so long as people in general could trust him to pay the gold against that note on its presentation, there was no reason why that note should not act as a medium of exchange, *i.e.* as money. It had not all the advantages of coin, but for large sums in particular, it rose superior to coin in one important quality, namely, portability. In the early days, of course, the bank-note was not legal tender, but for reasons which will be discussed later, most governments have found it advisable to pass laws making the notes issued by state banks legal tender. Thus Bank of England notes were made legal tender in 1833.

Another and less creditable form of note, which may receive a brief mention in passing, is that of the currency note issued by the Government itself. This is not a receipt for gold deposited in the Bank, but is nothing more nor less than a scrap of paper stating that the note represents a certain sum, *e.g.* £1, and that it is legal tender for that sum. In other words, the Government says "This scrap of paper by law is money and must be accepted as such by any creditor to whom it is offered".

Of course, if a private citizen could go to his desk and take out a half-sheet of notepaper and write across it "This bit of paper represents £1" and then be empowered by law to force his butcher to accept it in payment of his bill, he would obviously become a millionaire very quickly—except that we should see everybody doing the same thing, with the result that nobody would be any better off than before. Hence, the Government lays down by law that while it itself can do this and so overcome a budget deficiency, thereby qualifying to receive the thanks of the people for its excellent handling of an awkward financial situation, a private person acting

similarly on his own account is guilty of forgery and so qualifies for maintenance at the public expense in the nearest convict establishment.

It is, however, permissible for a private citizen to create money in various defined forms under various legal limitations. For example, he can issue a promissory note, *i.e.* if Mr. Smith owes Mr. Jones £100, he can write on a slip of paper "I.O.U. £100. Signed, John Smith", and if Mr. Jones chooses to accept it in exchange for goods supplied to Mr. Smith, well, that is Mr. Jones' business, and all the law will do is to see that Mr. Smith pays up in due course. Again, if Mr. Smith sells Mr. Jones goods to the value of £100, they can between them create a bill of exchange.

As a bill of exchange forms one of the most important forms of money, it is necessary to consider it at some length. The way it comes into existence is thus: Mr. Smith takes a bit of paper and writes on it "To Mr. Jones. Three months after date pay to my order One Hundred Pounds sterling, value received. Signed, John Smith". He presents this bill of exchange to Mr. Jones, who writes across it "Accepted, Jack Jones, 13th March 1928". To explain the above phrases, Mr. John Smith orders Mr. Jones unconditionally to pay to his order a given sum of money at a given date, and Mr. Jones by accepting the bill agrees to comply with the order. Now both by custom and by law this bill of exchange can act as a medium of exchange, *i.e.* as money. Thus if Mr. Smith owes Mr. Robinson £100 he can, if the latter agrees, take the bill and write across the back of it the words "Pay to the order of Mr. Robinson. Sgd. John Smith". This endorsement, as it is called, has the effect of ordering Mr. Jones, the acceptor, to pay £100 at a given date not to the drawer, Mr. Smith, but to the endorsee, Mr. Robinson. Similarly, Mr. Robinson can, by adding his own endorsement, make the bill payable to Mr. White, Mr. White to Mr. Black and so on and so forth. In other words, provided that everyone concerned agrees to receive this bill as payment of £100 due to him in each case,

the bill can and does act as a medium of exchange. It is not legal tender, *i.e.* nobody can be forced to receive it as payment. All the law does is to lay down a series of rules and regulations governing the whole use of bills. Thus the law sees that Mr. Jones, the acceptor, pays the bill in legal tender money, or in some way agreed upon by the final holder of the bill, on the date when it falls due. Furthermore, in case Mr. Jones goes bankrupt, or for any reason fails to pay the bill, the law enacts that the holder of the bill can come down on Mr. Smith, Mr. Robinson, Mr. White, Mr. Black and everybody else whose name appears upon the bill, and hold each in turn liable for the £100 due to him as holder. Incidentally, many governments lay down that bills of exchange should bear a revenue stamp. Governments, like the rest of us, have to live, and the stamping of a bill of exchange is a convenient form of tax.

Bills of exchange are described in various ways. Thus they may be drawn "Payable on demand" or "at sight"; *i.e.* the drawee (who on accepting it becomes the "acceptor") has to pay the bill when it is presented to him for acceptance. Alternatively, they may be "time bills", made payable at a definite time after the presentation to the drawee. The only essential point is that they must be payable at a definite date. Again, they can be described according to the currency in which they are drawn. Thus in foreign trade transactions they may be drawn in pounds, dollars, francs or marks. When an Englishman is selling goods to a Frenchman, they must agree between them as part of the terms of sale whether the bill is to be drawn in pounds or francs. A bill may even be drawn in a third currency. Thus a large number of bills are drawn in sterling even when neither the drawer nor drawee is domiciled in England, and the handling of these bills is an important part of London's financial business. Next, a bill may be drawn on a particular kind of institution; thus a bank bill is a bill drawn on, drawn by or endorsed by, a bank. In England, a Treasury bill is a bill drawn

on His Majesty's Treasury. As we shall see, the sale for spot cash of Treasury Bills payable at some definite future date, *e.g.* three months after issue, is a convenient way in which the British Treasury can borrow money for the short period over which the bill is to run. Finally, they may be described according to the purpose for which they are drawn. The normal bill is the "commercial" bill. This is the bill drawn in respect of a sale of goods by the drawer to the acceptor. If the bill is a time bill, and the drawer discounts it (*i.e.* sells it to a third party) at once, the bill is a means of providing the drawer with his money before the acceptor has to pay up, and it often happens that originally the goods are part of the security behind the bills. In these cases, the documents of title to the goods are attached to the bill, and it will then be called a "documentary" bill. As the bill changes hands, it may happen that the documents are detached, so that the buyer can obtain the goods. The bill then becomes a "clean" bill, and the security behind it is solely the names it carries.

Another form of bill is the "finance" bill. This is not drawn in respect of a sale of goods, but is simply a way in which one financial institution borrows money from another. The procedure is for one house to receive cash from the other, and in return to accept a time bill drawn upon it. The payment of the bill on its maturity is the way in which the debt is repaid. Like other forms of borrowing, finance bills may occasionally be abused.

The most common form of bill of exchange is the cheque. A cheque is a bill of exchange drawn upon a banker and payable on demand. It does not have to be accepted by the bank, but provided that all is in order it is paid straight away on presentation. The origin of a cheque is this. When a private citizen hands money to his banker for safe keeping he need not necessarily receive a bank note in exchange. Instead, the banker may simply make an entry in his books that he owes the depositor that much money, and he further

agrees to pay cheques drawn against that money so long as any of it remains in the bank. Thus when Mr. Smith draws a cheque on his bank in favour of Mr. Jones, he in effect orders the bank to pay that sum to Mr. Jones. When Mr. Jones presents the cheque the bank engages either to pay it in legal tender money to Mr. Jones or else to add the sum of money represented by the cheque to the total of Mr. Jones' deposit. In each case, of course, it subtracts the sum involved from Mr. Smith's balance. Of course, if Mr. Smith banks with one bank and Mr. Jones with another, then one bank debits Mr. Smith's balance while the other credits Mr. Jones' balance; also the latter's bank, known as the collecting bank, obtains from Mr. Smith's bank, known as the paying bank, the sum in question. The important point is that cheques, if not legal tender, are in other respects qualified to act as a medium of exchange, and in point of fact the cheque is the most common medium of exchange in use in many countries to-day.

CHAPTER VII

Prices—Their meaning—Supply and demand—Their connection with prices ”.

UP to now all that has been done is to define broadly the various kinds of money which exist, without considering how each kind comes into existence or, indeed, the whole mechanism of banking, currency and credit. The next consideration is the way in which money acts as a medium of exchange; in other words, the question of prices. We have already seen that instead of changing goods directly against goods it is far more convenient in every respect to exchange goods for money. It now remains to define the price of an article. The price of an article is the number of units of money which the buyer and seller together agree to exchange for that article. Thus if eggs are selling at twopence each it means that the buyer and seller of one egg between them agree to exchange that egg for twopence. Occasionally the price is expressed the other way round, thus the price of the eggs may be quoted as six eggs for one shilling. The next question to consider is what determines the price. Primarily, it is agreement between buyer and seller. Usually what happens is that the seller quotes a price; for example, a shop-keeper advertises his eggs at 2d. each, and it is open to the buyer either to accept that price or to beat the seller down, or to find some other seller. Certain prices are fixed by law; for example, postage stamps. Here the government also finds it necessary to enact that no one else shall undertake the carriage of letters. In general, as we shall see later on,

the price of an article can only be fixed where some form of monopoly exists, but underlying the agreement between buyer and seller is the whole question of supply and demand.

Supply and demand must be considered on both sides of the exchange. It is not only a question of the supply of and demand for eggs, but the supply of and demand for money. This in turn underlies the question of the natural resources of the world and of the psychology and calculations of the human beings who inhabit it. In our youth we learned that most commodities fall into three main classes, animal, vegetable and mineral. The supply of the first two classes is not wholly under human control. Drought, rain, cold, heat and disease are uncontrollable factors, and vary from year to year. Much has been done by the development of transport to link up various parts of the world and so to smooth out the effects of these factors. For example, favourable conditions in Australia may well coincide with unfavourable conditions in Europe or the United States, and when this happens, steamers will bring grain from Australia to fill the deficiency in the northern hemisphere. Yet even so, such staple commodities as grain, cotton and wool experience favourable and unfavourable years. At one time the supply may be fully equal to the world's needs, and at another will fall far short of it. With regard to minerals, the question takes a different form, and is best put this way. When a new mine is opened up, it is to begin with comparatively easy to work. The more that is extracted from it, the harder becomes the task of extraction, and sooner or later comes a time when the trouble involved in working the mine any further is greater than the world's needs for the production of that particular mine. When that occurs the old mine is abandoned and a new one is opened up. To anticipate the demand side of the case for a few moments, it is clear that should for some reason the world's needs for a particular mineral increase, certain mines which have been closed down can be and are reopened. These are then worked

to correspond to the new level of the world's needs and then once more abandoned. An example of this is found to-day in the closing down of many British coal-mines. British coal-mines were among the earliest to be worked, and there was a time when Britain supplied practically all the world's needs in coal, and the coal deposits in other countries were left untouched. The depression in the British coal industry to-day is thus in part due to the simple fact that many British coal-mines have been worked down to the point where, in accordance with the law given above, they have to be abandoned. For them to be reopened it is either necessary for the world's needs for coal to increase or else for human ingenuity to devise better ways of working the mines, so that they can be worked for a longer period with less trouble than at present.

The demand side is largely psychological. There are certain things we all must have, though many of them have substitutes which we can use if sufficient pressure is brought to bear upon us, and there are other things we can do without if we have to. For example, water we must have, and there is no substitute for it; that is why the state has stepped in to control the supply of water and fix the price to be paid for it. On the other hand, butter is only a comparative necessity of life, and if sufficient pressure is brought to bear upon us as was the case during the war, we can substitute margarine. Finally, articles such as gramophones and wireless sets are things we can very well do without if we have to, although they are equally pleasant for whoever can afford them. Now all this ultimately reduces to a question of price. If the supply of a certain article declines prices will rise. The same will happen if the demand increases. The reason is that those in possession of the article will, human nature being what it is, try to sell it to the highest bidder. Thus they will raise their prices until they reach the point where they can just sell all they possess without having any left upon their hands. On the other hand,

each successive increase in the price of an article will persuade some prospective purchasers that they are better off without it. There will always be some people who will wish to buy that article at any price, but the majority will only wish to buy it provided it does not rise above a given price, which they have determined in their own minds. There will, of course, be miscalculations on both sides—the seller may accept an offer from the first buyer only to discover later that if he had waited he could have obtained a higher price, while a buyer may make a purchase only to discover that he has paid more than another seller would have accepted. Again, as we saw in chapter five, a man may buy an article not because he needs it for himself, but because he thinks its price is going to rise so that he can sell it later on at a profit. A speculator may even sell an article which he does not possess because he thinks that the price is going to fall and that he can buy the article at a cheaper rate before he has to deliver it to the purchaser. Up to a point the whole question of price is a matter of trial and error, and at times the errors may be serious. This is as much as it is necessary to say at present. The relation between demand, prices and production costs are discussed more fully in subsequent chapters.

CHAPTER VIII

The connection between money and prices—The supply of money—Gresham's Law and its exception—The need for confidence—The two forces governing individual prices—The price-level—Index numbers—The quantity theory.

IN stating these laws of economics we have got some distance away from the money side of the price question. This is a totally different proposition. In the first place, it is not too easy to define the demand for money at all. From one point of view, indeed, the demand for money is infinite, for so long as the money remains good money, *i.e.* conforms to the standards laid down in the previous chapter, everyone wants as much as he can get. At the same time it is necessary to bear in mind that no one wants money for its own sake alone. The only use of money is that its possessor can subsequently exchange it for the goods and services he requires. The fact that an individual may steadily save money during most of his life, even with the idea of bequeathing it to his children after his death, does not affect the principle of this statement. The supply of money, too, depends on circumstances totally different from those affecting the supply of commodities. Where money takes the form of gold coin, obviously any increase in the total supply of gold due, for example, to the discovery of fresh gold-fields, will increase the supply of money. This new money will, of course, first of all be in the possession of the gold-miner, but as he uses it to buy whatever he needs, so will it pass into the possession of the community as a whole. Again, where, either by custom or by law, money takes the form of bank-notes or currency notes

issued by the State, then the supply of money is naturally a matter for the discretion of the issuing authority. Usually, as we shall see in the chapter upon banking, he exercises that discretion wisely and does not issue notes beyond limits governed by certain well-defined laws, but there is no guarantee that he will not issue paper currency to an indefinite amount, as the post-war history of such countries as Germany, Austria and Russia has only too clearly shown. Finally, in a country with a well-organised banking system where the main medium of exchange is a cheque drawn upon a banker, the power of the community to create money by drawing cheques depends upon the total of bank deposits which, as we shall see in the relevant chapter, is a matter largely within the discretion of the bankers. Here again bankers limit their deposits in accordance with certain well-defined laws, but in many countries there is no legal enactment that they shall do so.

There is, however, one well-known economic law governing the supply of money which has been handed down to us from Sir Thomas Gresham, who lived in the days of Elizabeth. This law, popularly known as Gresham's Law, states that where two or more different kinds of money are circulating side by side, the bad money drives out the good. Suppose that a country has two kinds of money, namely, gold coin and currency notes issued by the State, the notes not being redeemable in gold on demand by the holder—in such a case, while the gold coin will always be acceptable not only in this particular country, but also throughout the world, every holder of the currency note will be possessed by the latent fear that the note is not really as good as gold and that one day the government may repudiate its notes. In such a country, whenever an individual saved money, putting it in his safe or in his stocking, he would save the gold coin because he would know that that would preserve its value. Conversely, whenever he spent money, *i.e.* handed it to somebody else in exchange for something he needed, he would spend paper

money the permanent value of which was more open to doubt. That is why the money in circulation would generally consist of the "bad" money while the "good" money would be withdrawn from circulation and hoarded by its possessors. The principle of this law has been generally accepted right up to the present day, but the experience of the past ten years has suggested that the law is only true up to a point, and that if the bad money becomes very bad indeed, it in its turn tends to be driven out by the good. In Germany, between 1919 and 1923, the supply of paper marks was increased almost to the point of infinity. The paper mark became, therefore, very very bad indeed, so much so that instead of twenty of them being equivalent to £1 sterling, by the autumn of 1923 it required 20,000,000,000,000 paper marks to equal £1. During these later months of 1923 the paper mark was so bad that sellers of goods and services refused to accept it and insisted upon being paid in good money such as pounds, dollars and even in *ad hoc* marks representing a given quantity of some staple commodity such as rye, potash or even electrical power. This phase in German currency history was short-lived, because after a few months of this chaos the German Government succeeded in instituting a new and "good" mark. It lasted long enough, however, to show that money can become so very very bad as no longer to be able to drive out good money, but in turn to be driven out itself.

The real lesson of the law and its suggested modification is that a country's supply of money is not invariably homogeneous in character. So long as every kind of money in existence commands public confidence, then the coin, the bank-note and the cheque are all one as good as the other, but this will only be the case when the holder of a cheque knows that if he presents it to the bank he can get gold or notes if he so desires, and the holder of the note knows that he can get gold from the issuing authority if he wants it, or else that he can use it to make his own purchases with absolute certainty and freedom. In all countries with stable

currencies and banking systems such conditions obtain, and henceforward unless the contrary is stated, it will be assumed that they do obtain, but the qualifications suggested by Gresham's law must not be forgotten.

These last few pages have introduced several new considerations of money which already need explanation. To do so, we must revert to the connection between the supply of money and prices. We have seen that the price of a certain commodity, such as a bale of cotton or a sack of coal, depends upon the amount on offer in the market and the number of potential buyers. It also depends on something else, and that is, the amount of money in existence and the rate at which it is changing hands. These last two factors not only affect the price of one commodity such as coal or cotton, but affect the prices of all commodities alike. Suppose, for example, that in the course of the year the price of coal rises from 50s. to 60s. a ton. It may be that these figures will be due to the joint effect of two separate economic forces. The first force is that of the change in the supply of and demand for coal. If a big coal-field is worked out and abandoned, or if several thousand new houses, all with coal fires, are built in the course of that year, this will cause a rise in the price of coal and in the price of coal alone. On the other hand, if a new gold-field is discovered, or if the Bank of England issues a few more millions of pounds in notes and puts them into circulation, or even if the people of this country increase the rate at which they spend their money, the price of coal will equally rise, but on this occasion it is not only the price of coal that rises, but the price of everything else. Thus the hypothetical increase of 10s. per ton in the price of coal is really the resultant of these two sets of forces, and this is equally true whether or not both forces are uniting to bring about a rise, or the larger force is working for a rise and the smaller for a fall. The operation of these forces can be illustrated by the means of a very simple example. Suppose that the community bought and sold only four commodities, wheat, coal, cotton and iron,

and that the price of each of these commodities for two consecutive years was as shown in the following table:

	First Year.	Second Year.	Percentage Increase or Decrease.
1 quarter wheat .	50s.	75s.	Per cent. + 50
1 ton coal . . .	60s.	50s.	- 17
1 lb. cotton . . .	10d.	11d.	+ 10
1 ton iron . . .	75s.	75s.	no change
			average increase $+\frac{43}{4} = +10\frac{3}{4}\%$

The last column shows the percentage increase or decrease in the price of each separate commodity between the one year and the next. Each such increase or decrease is, as we have said, a resultant of two sets of forces, the one set arising from each particular commodity, the other arising from money, the common medium of exchange. Clearly, if we ascertain the average increase in all four commodities, we have eliminated the first set of factors arising from each commodity in turn and are left behind simply with the common factor arising from money alone. The example gives the average increase in price as $10\frac{3}{4}$ per cent; that means that the forces at work due to changes in the supply of money are such as to produce a general increase in prices of $10\frac{3}{4}$ per cent. We come now to a second table:

	Original Price.	Increase or Decrease due to Common Money Force.	Increase or Decrease due to Special Commodity Force.	Actual Increase or Decrease.
1 quarter wheat.	50s.	+ 5s. 4d.	+ 19s. 8d.	+ 25s.
1 ton coal . . .	60s.	+ 6s. 5d.	- 16s. 5d.	- 10s.
1 lb. cotton . . .	10d.	+ 1.07d.	- .07d.	+ 1d.
1 ton iron . . .	75s.	+ 8s. 1d.	- 8s. 1d.	no change

This shows, first of all, the change in prices due to the common "money" force; this, of course, is equal to $10\frac{3}{4}$ per cent on to the original price. Secondly, it shows the change in prices due to the special "commodity" force; this consists of the difference between the actual change as shown in the third column and the common or "money" change shown in the first. The third column gives the actual change, which now should be regarded as the resultant of the changes shown in the first two columns. It will be seen, as an example, that the rise in wheat prices is mainly due to the forces affecting wheat alone, possibly to a bad harvest or the increased consumption of bread. With regard to coal, the special force here was such as to cause a heavy fall, *e.g.* a new coal-field discovered and opened up. The same applies to iron, while a special force affecting cotton has produced a very slight fall, suggestive of a slight improvement in the crop. The common money force, of course, has produced an increase everywhere, such increase being directly proportionate to the original price of each commodity.

These calculations serve to introduce the conception of the general price-level. It is, of course, impossible to measure the absolute height of prices at any one time, simply because it is impossible to reduce to a common denominator the prices of every kind of commodity ranging from diamonds and silver to copper, pig-iron and coal. What can be done is to select any given date as a starting-point and to measure the percentage rise or fall in the price of each one of a representative selection of commodities between the fixed date and the present date. This is exactly what was done in the first of the two tables given above. Next, strike the average for all these percentages, just as is done in the table. Provided that the list of commodities is sufficiently representative, this average is a measure of the average increase in all prices during the period covered, and from this it is easy to proceed to the conception of the increase in the general price-level. The

example gives the price-level increase between the first and second year as $10\frac{3}{4}$ per cent.

The price-level has now acquired a meaning. Its absolute height at any given date cannot be measured, but the rise or fall between one date and another can be measured with a fair degree of accuracy. The mathematical instrument used in measuring it is known as an index number. Usually, the height of the price-level at the first or base-year is arbitrarily fixed at 100, and the index number for subsequent years is expressed in the form of a percentage, such as 90, 95 or 110; again reverting to the first table, the index number derived from the prices given in it is 110.75.

We can now link together changes in the supply of money with changes in the price-level. The link is this. All changes due to the common money force previously described affect all prices alike and in the same proportion, and therefore affect the price-level; and such changes are measured by the rise or fall in the index number of prices. On the other hand, any change due to a special commodity force mainly affects that particular commodity and has very little, if any, effect upon the general price-level. In fact, whenever the price-level rises it means that either the total supply of money or the rate at which money is changing hands is increasing more rapidly than the total volume of trade. Whenever the price-level falls, then the increase in the volume of trade is relatively greater than the increase in the supply of money or in the velocity with which it is circulating. It is this general relation which is at the base of the very controversial quantity theory of money, which states that the price-level is governed by the supply of money and its velocity of circulation on the one hand, and by the volume of trade on the other hand. The statement of the theory in this form, making the price-level dependent upon the other functions in the equation, is open to question, but there is no doubt that the equation itself is of great value in linking up money, trade and prices.

CHAPTER IX

Banking—Definition of a bank—A typical bank balance-sheet—How a banker earns his profits—Deposits and bank-notes—A banker's liabilities—The machinery of cheque payments—Cash and deposits—Relation between deposits and loans.

So far we have roughly defined various kinds of money and shown how money acts as a medium of exchange and how the supply of money and goods is connected with prices. We have included in our definition of money not only coined money and bank-notes, but bills of exchange and cheques. The next step is to show how these various kinds of paper money come into existence and what governs their birth-rate and their death-rate. In short, this chapter is concerned with modern banking systems.

A banker may be defined as an individual who borrows money from A and lends most of it again to C. Originally he did not borrow it from A on his own initiative but was asked by A to look after it for him until such time as A required it back again. In fact A used to pay the banker a small charge for the trouble the banker incurred in looking after it. The banker soon found that only a certain and small proportion of the money deposited with him was withdrawn at any particular time, and that as fast as one lot of money was withdrawn by one depositor another lot would be lodged with him by another. Thus, he might have on an average £1000 locked up in his vaults while the total amount paid out over his counter in any one day did not exceed £100. The banker saw that if he kept only £150 of that £1000 in his vaults, he was

perfectly safe to be able to meet any normal demands upon him by his depositors. From the discovery of this theory to putting it into practice was a very simple step, and the banker took it by lending the remaining £850 of the £1000 deposited with him to such people who needed a loan, could give good security for its repayment and could pay the interest the banker demanded. So long as the withdrawals did not outrun the banker's supply of cash, and so long as the loans were promptly repaid as they fell due, the banker remained solvent and could meet all his engagements to his depositors.

So soon as this fundamental principle was put into practice the banker no longer had to charge his depositors for keeping their money. Instead, the more money he could get deposited with him, the more he could lend and the larger profit he could earn. Thus it came about that instead of the depositor paying the banker for looking after his money, the banker paid the depositor for the privilege of obtaining his money and being able to use it. The interest paid to the depositor, of course, is less than the interest charged by the banker on his own loans, and if money is withdrawable by the depositor on demand, no prudent banker thinks of paying interest on such money; it is only on money which cannot be withdrawn without, say, a week's notice that the banker is prepared to pay interest.

Now let us draw up a typical bank balance-sheet:

First of all, every wise banker will put some of his own money into his bank as capital. This gives him a margin of protection, for even if every other depositor comes down on him to withdraw his money, the banker still has his own capital in hand. Say the banker pays in £1000. Next he obtains deposits to the amount of £10,000. Let £5000 of this be withdrawable on demand, or to use the usual banking phrase, let this be lodged on current account; and let the other £5000 be money withdrawable at a week's notice, *i.e.* money lodged on deposit account. This means he has

total liabilities of £11,000 namely £1000 to himself and £10,000 to his customers. He also has £11,000 which he can employ. He decides to keep in actual cash, *i.e.* legal tender money, 10 per cent of his total deposits, £1000. Another £1000 goes in buying and equipping his place of business. That leaves £9000, which he lends out to suitable people on suitable terms and at a suitable rate of interest.

TYPICAL BANK BALANCE-SHEET

<i>Liabilities.</i>		<i>Assets.</i>	
Capital	£1,000	Cash	£1,000
Current $\frac{a}{c}$	5,000	Loans	9,000
Deposit $\frac{a}{c}$	5,000	Premises	1,000
	<u>£11,000</u>		<u>£11,000</u>

Now see how the banker makes his living. Let him pay $2\frac{1}{2}$ per cent on the £5000 lodged on deposit account, and let him receive $4\frac{1}{2}$ per cent interest on his loans. Then his outgoings in a year total £125 and his income is £405. This leaves him a margin of £280 as gross profit out of which he has to pay his working expenses.

This is the fundamental balance-sheet of every banker in the world, and also the fundamental way in which the banker earns his living. The next point to consider is the various ways in which the depositors can recover their money, and the effect of such withdrawals upon the banker's balance-sheet and upon his business. First of all the depositor can withdraw cash. That clearly does not alter the form of the balance-sheet, but simply means equal reductions in deposits on the one side and the banker's cash on the other. Secondly, the banker may issue notes, *i.e.* the banker, instead of giving the depositor legal tender coin, may give him a bank-note, which as we have already seen is a written promise to the bearer to pay him legal tender money on demand. Say a banker issues to his depositors £2000 in

bank-notes, then his balance-sheet would take the following form:

<i>Liabilities.</i>			<i>Assets.</i>		
Capital	.	£1,000	Cash	.	£1,000
Notes	.	2,000	Loans	.	9,000
Current $\frac{a}{c}$	.	4,000	Premises	.	1,000
Deposit $\frac{a}{c}$	.	4,000			
		<hr/>			<hr/>
		£11,000			£11,000
		<hr/>			<hr/>

The banker is now no longer purely a deposit banker, but has also become an issue banker. His gross profit is greater, because he has £1000 less on which to pay interest, but his position is more vulnerable, for in place of £5000 current deposits payable on demand he has £6000 of notes and current accounts together, of which every penny is payable on demand. A wise banker would therefore call in some of his loans, and so add to his holdings of cash, even though it also diminished his gross income.

The last balance-sheet shows that a banker's direct liabilities take three main forms: (1) his capital (*i.e.*, the money put in by himself and, if he has a company, by his shareholders); (2) his notes; (3) his deposits. In addition, he may have certain indirect liabilities. Thus he may accept or endorse a bill of exchange on behalf of one of his customers; this will be discussed later. Now his notes are, as has been seen in a previous chapter, one of the well-known forms of money, and in some cases they may even be made legal tender by law; thus notes issued to-day by the Bank of England are legal tender. His deposits are equally a form of money, though not legal tender money. The reason for this is that a depositor can draw a cheque against his accounts, and use it to pay his debts; always provided that his creditor is willing to accept a cheque in payment.

It is worth while tracing exactly what happens when a cheque is drawn. Four parties are involved, the drawer and his bank, which is the paying bank, and the payee and his

bank, which is the collecting bank. First of all, set out side by side typical balance-sheets of the two banks.

A'S BANK (THE PAYING BANK)

<i>Liabilities.</i>		<i>Assets.</i>	
Capital . . .	£1,000	Cash . . .	£1,000
Deposits . . .	10,000	Loans . . .	9,000
		Premises . . .	1,000
	<u>£11,000</u>		<u>£11,000</u>

B'S BANK (THE COLLECTING BANK)

<i>Liabilities.</i>		<i>Assets.</i>	
Capital . . .	£1,000	Cash . . .	£900
Deposits . . .	8,000	Loans . . .	7,100
		Premises . . .	1,000
	<u>£9,000</u>		<u>£9,000</u>

A owes B £100. A draws a cheque on his bank payable to B's order, and hands it to B. B pays it in to his bank who collects it and credits it to B's account. To collect it B's bank sends a clerk with the cheque round to A's bank, and if A's bank agrees that the cheque is in order, *i.e.* that it is really drawn by A and is not forged and that A has sufficient money at the bank to meet it, A's bank honours it and pays over £100. These operations therefore take place. A's bank deducts £100 from A's deposit, B's bank adds £100 to B's deposit, and A's bank (the paying bank) pays £100 in cash to B's bank (the collecting bank). Now reconstruct the balance-sheets.

A'S BANK

<i>Liabilities.</i>		<i>Assets.</i>	
Capital . . .	£1,000	Cash . . .	£900
Deposits . . .	9,900	Loans . . .	9,000
		Premises . . .	1,000
	<u>£10,900</u>		<u>£10,900</u>

B's BANK

Capital . . .	£1,000	Cash . . .	£1,000
Deposits . . .	8,100	Loans . . .	7,100
		Premises . . .	1,000
	<hr/>		<hr/>
	£9,100		£9,100
	<hr/>		<hr/>

A comparison of these balance-sheets shows that the paying bank's deposits and cash have both fallen by £100, while the receiving bank's deposits and cash have both risen by £100. Incidentally, the paying bank's ratio of cash to deposits has fallen from 10 to 9·1 per cent, and the collecting bank's cash ratio has risen from 11·3 to 12·3 per cent, simply as a result of this one transaction.

We must now see what each of the two banks does about this change in its position. A's banker naturally wants to restore his cash ratio. To do that he must either increase his cash or reduce his deposits. In any case he calls in some of his loans. Now these loans are either repaid in cash or by a cheque drawn by the debtor on some other bank. In the first alternative clearly the banker adds directly to his cash by the same amount as he reduces his loans and achieves his object in that way. In the second alternative he equally adds to his cash by the same amount as he reduces his loan, because in this case he himself is the collecting bank, and just as he loses cash in the first instance so in this instance he gains cash. B's banker, on the other hand, has a bigger cash ratio than he needs. He is perfectly safe, but he is not using his assets to the full extent that he might. Thus his policy would be to make additional loans. By so doing he would reduce the amount of cash held in his vaults in exactly the same way as A's bank increases the amount of cash held in his vaults when he called his loans. Finally, let us see exactly by how much A's bank would have to reduce his loans and B's bank would have to increase his loans. A's banker has, after clearing A's cheque, deposits amounting to £9900. 10

per cent of £9900 is £990. Thus to restore his cash ratio to 10 per cent he has to make his cash up from £900 to £990, *i.e.* he calls in £90 of his loans. Similarly, B, to reduce his cash ratio to its original figure of 11·3 per cent, must lend an additional £85.

Now take another case. Go back to the original balance-sheets of the two banks and add together the loans and deposits of each. The total deposits of the two banks amount to £18,000 and total loans to £16,100. Now suppose that A owes B £100 and, as A has not got it, he goes to his bank and obtains a loan of £100. He then draws a cheque for £100 on his own bank and hands it to B, who pays it into his bank. Then this time, instead of the deposits at A's bank being reduced by £100, the loans at A's bank will be increased, but, as before, the deposits at B's bank will still be increased by £100. Add together again the deposits and loans of both banks. The total of loans has now risen by £100 to £16,200 and the deposits equally by £100 to £18,100. Also, equally important, the total of cash for the two banks remains unchanged at £1900, for while A's bank has lost £100 in cash, B's bank has gained it when the cheque was cleared. As will be readily calculated, A's bank's cash ratio has this time fallen to 11·1 per cent, but B's bank cash ratio has risen to 12·3 per cent as before.

This calculation illustrates the important principle that every time the banks of a country increase their loans they — equally increase their deposits, and as cheques drawn — against deposits are one of the recognised forms of money, increases in banker's loans mean a potential increase in the country's supply of money. This is the foundation of the general belief that the supply of money is mainly governed by the policy of the banks, on the ground that the more they lend, the more money there is about. Up to a point this is — true, but there is one vital qualification. Every banker, as — soon as he starts business, immediately lends right up to his margin of safety as measured by his cash ratio. Once he has

got down to the lowest cash ratio which he feels it safe to carry, he can only make fresh loans and so create fresh money if he has first been able to acquire additional cash, for we have seen that the creation of a fresh loan without the acquisition of fresh cash, means an immediate drop in his cash ratio. In short, a banker may have had, when he started, the power to create money, but every banker has long ago used that power to its utmost limit. What he can do in practice to-day is to destroy money by calling in his loans, and this he will refrain from doing for the simple reason that a reduction in his loans means equally a reduction in his profits. Thus unless a banker decides that henceforward he can operate on a lower cash ratio, his power to create money by extending his loans is to-day governed solely by his power to acquire additional cash, a matter which is not within his control.

CHAPTER X

A banker's assets—Call money—Bills of exchange—The rate of discount—
Investments—Loans.

THE next subject is that of the various forms of bankers' assets. Cash we will leave for the moment. His loans fall to-day into four main forms.

(1) *Call money*, i.e. money which can be called in at short notice. This is money loaned for a day or a week to the Money Market and Stock Exchange as described in subsequent chapters. From the banker's point of view it carries a low rate of interest, but its great merit is that it can be called in quickly and turned into cash. It is thus his first line of defence when he finds his cash ratio becoming too low.

(2) *Bills of Exchange*.—A bill of exchange was defined in a previous chapter, where it was treated mainly as a form of money. It is now necessary to show that it is more than that. For the drawer and acceptor it is a means of obtaining a loan for the period the bill has to run. To the banker it is a form of loan which is very secure and very easily turned into cash. Suppose A draws a bill on B, payable in three months' time, in respect of goods delivered by A to B at the time the bill is drawn. Clearly, B has obtained a loan for three months, for he has obtained the goods at once, and he does not have to pay the bill until the end of that period. The question is, from whom does he obtain the loan. If A holds the bill until maturity, it is clearly A who is lending B the money, but A in

his turn may need cash at once, so he goes to his banker and discounts, *i.e.* sells the bill. The bank, by buying the bill, has thus replaced A as the lender of the sum advanced to B, and unless the banker sells the bill in his turn, he will be lending this money until the date on which the bill matures. Thus, a banker's holding of bills is one form of a banker's loans. It is a form which has two great merits. In the first place, the security is good, for as was shown in a previous chapter, if B fails to pay the bill on maturity the banker can come down on A for it, and indeed upon anybody else whose name is on the bill. Next, it is a loan repayable at a definite date, *i.e.* at the maturity of the bill. Both these points are of vital importance to the banker, who is lending not his own money, but money deposited with him by his customers and repayable either on demand or at short notice.

It may be asked how it is that the banker earns any profit on the bills he buys. The answer is a simple one. When a banker buys a bill for £100 he does not pay the full £100, but £100 less the current rate of discount on bills of that class. The rate of discount is a technical term describing the rate of interest on the bills, but instead of adding the rate to the face value of the bill it is deducted. The reason for this is a simple one. If a banker or anyone else makes a loan of £100 at 5 per cent interest, he expects to be paid £100 plus £5. On the other hand, if he buys a bill value £100, he is only going to receive £100 at a future date when the bill falls due, therefore, to earn his profit he must pay for the bill £100, less the rate of discount. The rate of discount is a matter for negotiation in the money market that deals in these bills. If several banks are wanting bills they will have to pay more for them, *i.e.* a figure closer to the £100, and so the discount rate will fall perhaps to 3 per cent. On the other hand, if nobody wants bills and everyone is selling them, they will become cheaper, and so the rate of discount may rise to 4, 5 or even 6 per cent. The chief discount rate quoted in the money market is the rate of discount on three months' bills, carrying the

name of a London bank or, more shortly, the rate on three months' bank bills. This rate is known as "market rate", *i.e.* if the market rate is 4 per cent per annum, a three months' bank bill for £100 can be bought and sold for £99, simply because 4 per cent per annum equals 1 per cent for three months. When a banker is offered a bill carrying names of doubtful reputation, if he buys at all he will not buy at the market rate of 4 per cent, but by way of insurance will want a rate of, say, 6 per cent or 7 per cent. Thus for a three months' bill he will not pay £99 but somewhere round about £98:5s. to £98:10s. The additional 10s. or 15s. is insurance against the bill not being paid.

(3) *Investments*.—A banker will use part of his assets not in buying bills or making loans, but in buying stocks and shares of first-class security, these being in practice mainly British Government and British Corporation or Colonial Government stocks which carry definite rates of interest. Further consideration of stocks and shares will be reserved for the chapter devoted to that subject.

(4) *Loans to Customers*.—These represent loans of all sorts and descriptions to customers and banks. They may take the form of a loan of a definite sum of, say, £20,000 to a big municipality or manufacturing company, or they may equally be an overdraft of £15 or £20 to a small suburban customer. They all have three factors in common. They carry interest at rates subsequently discussed. They are either made to people whose power to repay at the point of time is beyond question, or else they are made against the security of various kinds of property such as sound stocks and shares or marketable produce which can be easily realised if the loan is not repaid. Finally, they are only made for short periods, not exceeding, as a rule, six months. Here again the banker has to be careful, for he is not lending his own money, but his customers' money, which he is bound to repay at short notice. In short, in whatever way a banker employs his assets, the one rule he is bound to keep is that any loan he

makes, any bill he buys, or any investment he holds, must be thoroughly liquid, *i.e.* that he should be able to call it in
- and turn it into cash at an early date or on a date which he
- had calculated in advance at the time he made the loan or
- bought the bill.

CHAPTER XI

Various kinds of banks—The central bank—The Bank of England—Its Issue Department and note issue—Its Banking Department—The Bank's reserve.

THE foregoing description of a bank is in the main true of all kinds of banks whose chief business is the issue of notes or the acceptance of deposits. It now remains to discuss the various kinds of banks in existence in England, to show the functions they perform and also the effect they have upon the supply of money and the general economic conditions of the country. There is one important point which should be added before proceeding to the question, and that is that bankers not only accept deposits from the public, but also from each other. In such cases the one bank would include in its deposits the deposits from other banks, while the bank making the deposit would show among its assets an item "balances with other banks". In particular, most countries to-day have what is known as a Central Bank, which acts as the banker of the government of the country and also of the other banks, *i.e.* its deposits consist not of money lodged by the public, but money lodged by the government and the other banks.

The Central Bank has other important duties. It holds the gold stocks for the country, it acts as banker to the government, it administers the National Debt so far as the routine work is concerned, and it gives the lead in fixing rates of interest and discount current in the money market and in the banking world.

In England the Central Bank is the Bank of England.

originally started as an ordinary bank of issue and deposit, but which gradually drifted, after many vicissitudes, into the position of the country's Central Bank, which it has occupied for the last fifty years. By Peel's Bank Act of 1844 it was divided into two parts, namely, the Issue Department, concerned solely with the issue of notes, and the Banking Department, which is a bank carrying deposits mainly of the government and of other banks. Its method of operation is most simply explained by analysing the Bank Return, which is the balance-sheet issued by the Bank of England every week. The following table shows the Bank Return for May 29, 1929:

BANK OF ENGLAND

Return for Week ended Wednesday, May 29, 1929

ISSUE DEPARTMENT

Notes Issued—		Government Debt	£11,015,100
In Circulation	£360,106,563	Other Government Securities	236,205,685
In Banking Department	62,360,708	Other Securities	7,945,442
		Silver Coin	4,833,773
		Amount of Fiduciary Issue	260,000,000
		Gold Coin and Bullion	162,467,271
	<u>£422,467,271</u>		<u>£422,467,271</u>

BANKING DEPARTMENT

Proprietors' Capital	£14,553,000	Government Securities	£40,031,855
Reserve	3,252,573	Other Securities—	
Public Deposits*	24,340,708	Discounts and	
Other Deposits—		Advances	£8,151,163
Bankers	£56,349,043	Securities	22,422,917
Other Accounts	35,268,620		30,574,080
	<u>91,617,663</u>	Notes	62,360,708
7-Day and other Bills	5,368	Gold and Silver Coin	802,669
	<u>£133,769,312</u>		<u>£133,769,312</u>

* Including Exchequer, Savings Banks, Commissioners of National Debt and Dividend Accounts.

To take the Issue Department first. According to the Currency and Bank Notes Act of 1928, the Bank issues notes up to the amount of gold it holds plus a fixed figure of £260,000,000, this last being called the "fiduciary issue". Until the outbreak of war the Bank issued notes to less than £20,000,000, in excess of its gold stocks, and the bulk of gold in the country was held not by the Bank, but by the

Joint-Stock Banks and by the public generally. The effect of the war was to concentrate the country's gold in the hands of the Bank of England and also to increase the volume of currency in circulation in the country. From 1914 to 1928 these extra notes, which at the end of the war ran into several hundred millions, were issued not by the Bank of England, but by the government. The Act of 1928 made the Bank the sole issuing authority and fixed the fiduciary issue at £260,000,000, this limit being arrived at by setting the country's outstanding currency notes against the country's gold stocks. The first four items shown by the total of £260,000,000 in the account represent (a) the original government debt to the Bank, dating from the early days of the Bank of England; (b) the silver coin held by the Bank; and (c) such other securities, whether issued by the government or consisting of commercial bills of exchange and other securities, that the Bank requires to make up the total of £260,000,000. These securities, just like the assets of any bank, must be thoroughly sound and liquid. For example, where bills of exchange are held, they are first-class bills, maturing at an early date. The Liabilities side of the Issue Department is easily explained. The term "notes in circulation" represent such notes as are in the hands of the other banks and of the public. The balance "notes in Banking Department" here represents simply the difference between the notes issued by the Bank and the notes in circulation. The size of this last item very clearly depends (a) on the gold held by the Bank, and (b) on the notes withdrawn for circulation. The system used by the Bank of England is known as the system of a "fixed fiduciary note issue". The division of the Bank into the Issue and Banking Departments is also peculiar to the Bank of England, and is not found in other central banks. The majority of foreign central banks use the "ratio system". Here, the gold (or gold exchange) stocks of the central bank must not fall below a minimum percentage of the bank's liabilities to the public

and its customers, such liabilities including both notes and deposits. This percentage is often about 40 per cent.

Turning now to the Banking Department, on the Liabilities side there are first of all two items, Capital and Rest. These represent the amounts originally subscribed by the Banks' proprietors, and also the Bank's undivided profits, which, of course, are equally the property of the proprietors. Next come Public Deposits, these being deposits by various government authorities as described at the foot of the return. Next come Other Deposits, divided into two parts—Bankers' and Other Deposits. Bankers' Deposits are the deposits of all other British banks which, as shown later, the banks in their turn count as cash when enumerating their assets. Other Deposits consist of deposits by all private individuals, including deposits by foreign central banks. The last item, Seven-day and Other Bills, is an historic survival and is of only minor importance.

On the Assets side of the Banking Department we have, first of all, Government Securities, consisting of all kinds of government stocks and other loans made by the Bank to the government. These include (a) ordinary stocks such as Consols, Conversion Loan, War Loan, etc.; (b) Treasury bills, which have already been defined; and (c) Ways and Means of Advances to the government, which are simply loans made by the Bank to the government. Other Securities are, like Other Deposits, divided into two sections. The first is Discount and Advances. These are bills discounted for the Money Market and loans made to the Money Market on the Market's own initiative, *i.e.* a member of the Market goes to the Bank and asks the Bank to discount a bill or make him a loan. This the Bank is always prepared to do on its own terms. Next we have Securities. These are commercial bills and other securities bought by the Bank on its own initiative, *i.e.* the Bank goes itself into the Money Market and asks to be sold bills, and here, of course, it has to take such terms as it can arrange in the Market. Finally

come two items, Notes and Gold and Silver Coin, the latter being relatively small and unimportant. These two items together form what is commonly known as the "Bank's reserve". Its size is of fundamental importance to the financial world, and by referring back to the description of the Issue Department it will be seen that its size depends (*a*) on the amount of gold held by the Bank, and (*b*) on the amount of its notes withdrawn for circulation.

CHAPTER XII

British joint-stock banks—Their cash holdings—Their deposits and the country's supply of money—Maintenance of their cash ratio—The banks and the money market.

NEXT come the Joint-Stock Banks, such as the Midland, Westminster, Barclay's, etc. In England to-day these are mainly large organisations consisting of hundreds of branches in all parts of the country, controlled from one central head office. Their balance-sheet is the aggregation of the assets and liabilities of each one of these branches and takes the form, with one important modification, of the balance-sheet of the typical bank already described. The modification is to be made in their holdings of cash. Their cash does not consist of gold, but takes three different forms. First we have subsidiary coinage, namely, pence, shillings, half-crowns, etc. Next come Bank of England notes, and finally comes the bank's own deposit at the Bank of England. These three together the bank reckons as its cash, and when it calculates its ratio of cash and deposits as previously described, it sets the total of these three items against the total of its deposits. It governs the size of its cash by two considerations. Firstly, it holds enough notes and subsidiary coins at each one of its branches to meet the usual demands of the customers at each branch. In addition to this it holds a big enough deposit at the Bank of England to bring its total of cash up to the level of an adequate cash ratio, which in practice is somewhere round 11 or 12 per cent.

Thus besides subsidiary coinage, the country's supply of

money consists of (a) deposits at the Joint-Stock Banks; (b) Bank of England notes held by the public. Deposits at Joint-Stock Banks are based partly on bank-notes, partly on Joint-Stock Bank deposits at the Bank of England. These in their turn are based on the reserve of notes and coin in the Banking Department. Finally, Bank of England notes, whether held by the public or by the Joint-Stock Banks or in the Banking Department's reserve, are all based on the country's gold stocks plus the fiduciary issue of £260,000,000.

The next point is to see how the country's supply of money is governed. The Joint-Stock Banks have long ago increased their loans and deposits to the point where their cash ratio is as low as they think it safe to have it. This means that if they wish to make fresh loans and increase their deposits, they must obtain fresh cash in the form either of notes or of their deposits at the Bank of England. Now to add to their stock of notes they must get notes either from the Bank of England itself or from the public. The public's ability to supply notes is in practice limited, because there are certain broad classes of payments such as wages and purchases at shops which customarily are made in notes and coin and not by cheque. In fact, the common experience is not that the banks can succeed in getting additional notes out of the hands of the public, but that the public at certain times of the year draw extra notes from the banks. It must be remembered that the public's deposits at the banks are the property of the public and are withdrawable by the public in legal tender money on demand. At Christmas, Easter and other holiday periods the public normally withdraw part of their deposits in notes, *i.e.* they get extra notes from the banks. The banks can in their turn get more notes from the Bank of England, but when they do so they automatically reduce the Banking Department's reserve, which is the basis of their own deposits at the Bank of England. This is a step which normally they are loth to take. The

next question is, can they in any way add to their deposits at the Bank of England? Here again they are to a certain extent at the mercy of other people. For example, when one of their customers pays his income tax, he does so by cheque, and the result is to transfer money from the Joint-Stock Bank's deposit to the government's deposit at the Bank. Again, while in certain countries the ordinary bank can borrow from the Central Bank or rediscount, *i.e.* sell some of their bills to the Central Bank, thereby adding to their cash, in England, banks by custom do not obtain accommodation by this means. There is, however, one important and common way in which a British Joint-Stock Bank can add to its deposits in the Bank of England. One of its assets is money lent at call or short notice to the Money Market. If it needs more cash it calls that loan from the Market. If it can, the Market pays it by borrowing from some other Joint-Stock Bank or other source, in which case the calling bank obtains more cash and the lending bank gives up some of its cash. If, however, all the banks are calling at once, the Money Market has to exercise its privilege of discounting its bills or borrowing from the Bank of England itself. In this case, bankers' deposits as a whole increase and so do Discounts and Advances at the Bank of England. To sum the matter up, the Joint-Stock Banks are too proud to borrow themselves from the Bank of England, but they have no objection to forcing the Money Market to borrow and hand over the proceeds.

CHAPTER XIII

Gold—The gold standard—The gold bullion standard—The gold exchange standard—Relation between gold, notes and bank deposits.

TO-DAY gold is not in circulation inside the country. The reason is that while the Bank is bound by law to redeem its notes in gold, the law also lays down that it is not bound to give gold against its notes in less quantities than 400 oz. of standard gold. Now the £ sterling consists by law of 123·274 grains of standard gold, which means that 1 oz. of standard gold is worth very nearly 85s. In fact the law definitely lays down that the Bank is bound to sell gold at 77s. 10½d. per standard oz.; just as the Bank is equally bound to buy gold at 77s. 9d. per standard oz.* This means that no one can obtain gold for notes unless he presents to the Bank notes to the value of nearly £1600 and is prepared to take away a 400 oz. bar of standard gold. This law, which was passed in 1925, is deliberately intended to prevent gold passing into circulation in the country. At the same time, if any bank or international finance house has a big payment to make in a foreign country and finds it cheaper to make that payment in gold, it is perfectly free to go to the Bank of England and withdraw gold for that purpose, and where big payments running into thousands of pounds are involved, the limitation of withdrawals to bars of 400 oz. creates no direct difficulty.

* Until the summer of 1930, the Bank as an act of grace sold fine gold bars at 84s. 11½d. per fine oz. Its buying price for fine bars is 84s. 10d. per oz.

It may here be convenient to distinguish the various main monetary systems. First of all there is the full gold standard, under which gold coin circulates freely and the issuing bank is bound to redeem all its notes in gold on demand. This was in force in England and other countries before the war and in the United States to-day. Next comes the gold bullion standard, which is in force in England to-day and has already been described. The principle of this is that gold can only, in practice, be withdrawn by those requiring it in large quantities. This limits withdrawals to purposes of foreign payments and excludes petty withdrawals for internal use. Next comes the gold exchange standard. This is a little more difficult to explain, but it may best be approached by reminding the reader that the Central Banks of different countries habitually make deposits with each other. Thus the Reichsbank will have a substantial deposit at the Bank of England and also a deposit at the Federal Reserve Bank in New York. Under the gold exchange standard a Central Bank is not bound to redeem its notes in gold. All it is bound to do is to give in exchange for notes presented a cheque drawn upon its balance with some other Central Bank whose notes are redeemable in gold either under the full gold standard or the gold bullion standard. Thus, when the gold exchange standard is in force in Germany, a German tendering notes to the Reichsbank will receive, for example, a cheque upon the Bank of England, and if he really wants gold he will have to take the cheque to London and present it to the Bank of England, who will give him gold in bars of 400 oz. Finally comes paper currency systems, where notes issued by the Government or central banks of a country are not redeemable in gold at all. The important point to emphasise here is that in any form of the gold standard, gold is ultimately the basis of the country's money, whether such money takes the form of notes or bank deposits. The process of turning notes or cheques drawn against bank deposits into gold may be a long and complex

one, but if it is pursued to the bitter end, gold can ultimately be obtained. Hence where a gold standard is in force a general feeling of confidence exists in the country's money and the country's banks, because the public know that the currency and banking policy are so adjusted that if anyone should happen to require gold, the gold is there for him to get. In short, the supply of currency and the volume of bank deposits are governed in the last resort by the supply of gold. Thus the Bank of England watches very carefully the ratio between its reserve of notes in its banking department and the size of its deposits in that department, and when that ratio gets too small it takes steps to increase it in a manner subsequently described. Similarly the Joint-Stock Banks watch the ratio between their cash and their deposits, and if the ratio begins to get too small they take steps by calling their loans or reducing their holdings of bills and securities to increase their cash ratio.

CHAPTER XIV

The money market—What it deals in—Its members—Merchant bankers—
Their function as acceptors of bills—And as issuing houses—The
discount houses—The bill-broker.

FREQUENT reference has been made to the Money Market, and this must now be described. As its name implies, it is a market in which money is bought and sold. Now as money is a medium of exchange, it may seem that a market solely for the purpose of buying and selling money itself is meaningless, even ridiculous. But it is necessary to distinguish between various kinds of money. There is, first of all, money on the spot. A bank-note is to its owner money on the spot. A current account at a bank is in a sense money on the spot, because its owner can go to the bank and withdraw legal tender money out of his deposit on demand. A bill of exchange on the date of its maturity is in a sense money on the spot, because the holder can present it to the acceptor and demand payment. The next kind of money is money due at some distant date. If I lend a friend of mine £100 for three months, that £100 is no longer money on the spot, for I have agreed not to demand repayment until three months have elapsed. Again, if I hold a bill of exchange maturing in three months' time, this is not money on the spot, for I cannot demand payment until after three months have elapsed. In both cases, however, I can turn it into money on the spot by selling to somebody else for spot cash either the right to the repayment of my loan or my bill of exchange. In either case I naturally cannot expect the full value of my loan or my

bill, for the buyer has relinquished to me some of his actual cash in return for the right to money at a distant date and with a certain element of risk that the loan or the bill will not be met when it falls due. The actual price I shall obtain for my loan or bill is a matter of negotiation between me and the buyer, and the moment this question arises we have all the elements of a market. In short, the Money Market is a real market in which money due at some distant date is exchanged for money on the spot. It is thus clear that the conception of a market dealing purely in money is no longer ridiculous, because it is a market in which one form of money is exchanged for another.

The chief classes of members in the London Market are as follows: (1) the Bank of England, (2) British Joint-Stock Banks, (3) the London offices of foreign banks, (4) merchant bankers, (5) the Discount Houses and Bill-brokers. The first two have already been discussed. The London offices of foreign banks fundamentally resemble the ordinary British bank. They exist mainly for the convenience of such customers of the foreign bank as may be visiting London, and also for those customers who are engaged in financial trade between London and a foreign country. They also have to earn their share of the banks' profits, and to do this they make loans, buy bills and hold investments just like any other bank.

Merchant bankers are not banks in the ordinary sense of the word. That is, they do not issue notes or accept deposits from the general public though they take deposits from certain clients. To-day they have two important functions. The first is that they accept bills on behalf of their clients who are situated in all parts of the world. Thus, if I sell goods to someone in South America and draw a bill of exchange on him against those goods, it is clearly desirable that I should be able to get the bill accepted in London, for by so doing I can avoid the delay that will occur if I have to send the bill out to South America for acceptance and

then have it returned to me. Also, if in place of acceptance by an unknown firm in South America I can obtain the acceptance of a well-known London banking firm, I shall find it much easier to discount my bill if I want to turn it into cash before it falls due. To amplify the second point, trade is largely a matter of mutual knowledge and confidence. I may get an order from an unknown customer in South America which I may have to turn down simply because I myself do not know that the customer is good for the money. But a merchant banker in London may know that the customer is good for the money, and so will be prepared to give his acceptance to the bill. I, in my turn, know that the merchant banker is good for the money ten or one hundred times over, so that his acceptance is good enough for me. The result is that, thanks to the intervention of the merchant banker, I can take this order which otherwise I would have rejected. The merchant banker, then, by giving his acceptance, plays an important part in the country's trade. It is a clear case of the lubrication function described in an opening chapter. It may be added that it is part of his main business, and by exercising this function he is often known as an "accepting house". Of course, like everybody else, he does not perform this function for nothing. Whenever he gives his acceptance to a bill on behalf of one of his clients he always charges that client a small commission, such as $\frac{1}{8}$ per cent or $\frac{1}{4}$ per cent on the value of the bill. Of late years the joint-stock banks have taken a share in this business, and to-day they are prepared to accept or endorse approved bills of exchange drawn on their customers. This acceptance appears as an item in the ordinary bank balance-sheet, on both sides of the account, as "Acceptances and endorsements on behalf of customers". By accepting a bill in this way the bank undertakes to pay it and to recover the proceeds, hence it is shown as part of his liabilities as "Acceptances on behalf of customers", and as part of his assets as "Customers' liability for acceptances".

Such assets and liabilities are of a contingent nature for they only come into force when the bill matures. Hence a bank does not include them in its calculation of its ratio of cash.

The other main function of the merchant bank is to issue loans on behalf of foreign governments and municipalities, etc. This means that it does all the work of issuing to the investing public an invitation to subscribe to a loan required by a foreign government. By its knowledge of conditions in London it is able to decide on the most suitable terms for the issue, such as the rate of interest the stock can bear and the price at which it should be issued. Here again it performs a function of lubrication. The foreign government knows nothing about current conditions on the London Stock Exchange, and if it attempted to raise a loan directly on its own account the terms it would offer would be either too generous or too unattractive. On the other hand the British investing public may know nothing about the foreign government, and may only be prepared to subscribe if it knows that a famous London house is sponsoring the loan. The merchant bank does more than the actual routine work of issuing the loan. It may, for example, supply the bulk of the money to the foreign government some time before the loan is issued, *i.e.* it makes a temporary loan to the foreign government in advance of the permanent one. Alternatively, in certain cases it may, after the loan has been subscribed, retain the money in London on behalf of the foreign government until such time as the foreign government wants it paid over. In all this business it must again not be thought that the merchant bank does all this work for nothing. If it makes a temporary loan to its client it will charge interest, though it will equally pay interest if the money is left with it after a permanent loan has been subscribed. In any case it will require payment for the actual work of issuing the loan. A common way of obtaining this payment is for the issuing

house to offer the stock to the investor at a price, say, of £95 per £100 stock and then pay over to the real purchaser only £93 out of every £100 stock subscribed. The margin of £2 pays the issuing house for its work.

Next comes the Discount Companies and Bill-brokers. There are three large companies and a number of small firms in existence in London to-day. Their mode of operation is a very simple one. Their reserves are partly the capital subscribed by their own shareholders or partners, partly deposits lodged with them by others, and partly short loans raised in the market. To some extent they appear to resemble a bank, but they are not bound to repay their deposits in legal tender money. If the depositor withdraws, say, £10,000 from his deposit with a Discount Company, all that the Company is bound to do is to hand him a cheque for £10,000 drawn upon the Discount Company's bank. The assets of a Discount Company consist mainly of bills of exchange, although it always keeps a certain amount of cash on deposit at its bankers, and also a certain proportion of its assets invested in high-class stocks. By making its main business that of buying and holding bills of exchange it also performs a useful function, for when it buys a bill it supplies the former holder with spot cash in advance of the maturity of the bill.

The dividing line between the Discount Companies and most firms of Bill-brokers is a very indeterminate one. All are engaged in buying, holding and selling bills, financing their operations largely by short loans from the banks, these last being mainly for a week. There is, however, a class of bill-broker known as a "running-broker". The distinction between him and other bill-brokers is that he seldom buys bills for his own account. Instead, he acts as a true "broker" or agent for others who employ him, often on commission, to obtain such bills as they require. The need he fills is a very simple one. Banks and other people who buy bills always adjust their holding of bills so that they have a

certain number maturing at various dates, *i.e.* so many at the end of one month and so many at the end of the next, and so on. On the other hand, bills are drawn every day, maturing at all sorts of dates, and the function of the running-broker is to trace these bills as they come into existence and then to go round the market offering these bills to any likely buyer and leaving that buyer free to take bills maturing at such dates as he requires to complete his holding.

CHAPTER XV

The money market continued—How it works—Money and discount rates—Bill-brokers and bankers—The Bank of England's function—Bank rate defined—Borrowing from the bank—Bank rate and other money and discount rates.

HAVING described the general principles of the London Money Market, it is now possible to describe the operation of the market itself. Fundamentally it is a market in which money is being continually lent by those who have a surplus, and borrowed by those who need money with which to finance their holdings of Bills of Exchange. It is thus a double market, firstly in loans and secondly in Bills of Exchange, for the same bank that makes a short loan to a broker or discount house may also be buying bills. Two sets of rates are also quoted every day in this market, namely, the rates of interest on loans and the rates of discount on bills. When money is "tight", *i.e.* hard to borrow, short-loan rates run high, while when money is easy it may run down to as low as 2 per cent or even to 1 per cent. The clearing banks, however, lend their weekly money, which forms the market's main source of supply, at a definite rate of one point below Bank rate. Again, when bills are plentiful and there are few buyers, discount rates will run high, while, conversely, when there is a keen demand for bills, rates will run low. Interest rates on short loans and discount rates on bills are thus really determined by supply and demand and are in a sense akin to the price of a commodity. The more loans are wanted the higher interest rates will be, the less bills are wanted the higher discount rates will be. The reader

may be reminded that to determine the current price of a bill a deduction must be made from its face value proportionate to the length of time the bill has to run and the current rate of discount, *i.e.* the price of a three months' bill for £100 will, at a discount rate of 4 per cent, be £99. This is the explanation of the apparent paradox of the statement that the less bills are wanted the higher discount rates rise.

The key to the Money Market is the bill-broker. Every morning he makes his round of the banks, merchant bankers and other houses, first of all to renew his loans, and, secondly, to buy and sell bills. British banks are only buyers of bills, for they make it their rule never to sell. The London offices of foreign banks and merchant bankers both buy and sell, and all institutions lend short money for a day or a week to the bill-brokers and also to the discount houses. Thus, when a broker enters a bank manager's parlour he has two things to find out, firstly, whether the manager can renew his loans which form the bulk of his working capital, and secondly, what bills of what description and maturing at what date the bank requires. The manager in his turn knows the state of his bill portfolio, and in particular what bills he requires to give him the necessary number of bills maturing at given dates. For example, he will want so many bills maturing every week, and it is also convenient for him to have an extra supply of bills maturing on such dates as the end of the half-year when he knows he will require to augment his cash holdings. The manager also has before him a statement showing roughly what cash he will have coming into his bank during the day and what cash he will have to pay out. Some of the items in this statement will be definitely known. Thus a bank may have engaged to pay out a big sum to, say, a foreign government. Others must be deduced from the bank's general experience. For example, he has a good idea of the ebb and flow of cash due to the clearing of cheques drawn on the bank by his thousands of

customers. With this statement before him the manager can see how much money he is likely to be "short" or "over" at the end of the day. If he is going to be "short" he calls his loans from the market, *i.e.* he refuses to renew his loans outstanding with the bill-broker. If he is going to be "over" he will, as the day goes on, offer loans more cheaply in order to induce the bill-brokers to borrow more and so employ his surplus cash. If the bill-broker can renew his loans well and good, but if not he promptly hurries off to the next bank and sees if he can meet with better luck there, in the hope that although one bank is calling, another bank may have additional money to lend. He will also quote a higher discount rate on his bills in the hope that he will, by thus cheapening them, be able to sell part of his holdings and to counteract the pressure put upon him by the fact that some of his loans are not being renewed.

At times it happens that money is tight all round, *i.e.* for one reason or another all the banks are calling their loans. This often happens in the spring, because at that time a bank's customers are busy drawing cheques in settlement of their income tax and large sums are drawn, or rather are transferred, not from one bank to another, but from all the banks to the Government's account at the Bank of England. Again, at the end of December or the end of June most banks like to show in their half-year balance-sheets a large supply of cash for the purpose of reassuring their shareholders. For this reason again, they all call their loans at once. Now, what has the unfortunate bill-broker to do at such a time? There is one bank that will never fail him and which, in the last resort, will lend him money or buy his bills without limit. That bank is the Bank of England.

Each Thursday morning the Bank of England's directors meet and announce the Bank rate for the coming week. Bank rate is the minimum amount of discount at which the Bank of England will discount bills for other than their customers; that is to say, the rate of discount at which the

Bank will buy first-class bills of exchange with about twenty-one days to run from all and sundry without limit. The Bank also agrees to lend money to bill-brokers at a rate $\frac{1}{2}$ per cent above Bank rate, but it will not make these loans for a shorter period than one week, and if on any day they have run up to a certain limit further borrowers on that day have to borrow for eight days until that quota is filled, the next lot for nine days and so on. At times of stringency it has been known for brokers to borrow for as much as twelve or even fifteen days. Now it is perfectly clear that as the Bank engages to discount bills at Bank rate without limit, the rates of discount current in the market for short bills of a month's maturity or less can never rise above Bank rate, just as the price of a commodity can never fall below the point at which a particular customer is prepared to buy without limit. Thus all fluctuations in discount rates on short bills take place below Bank rate. It must also be pointed out that while short-loan rates fluctuate within fairly wide limits, the average short-loan rate will normally* be lower than the market discount rates on bills, for it is on the margin between the two that the bill-broker depends for his profit. A broker who is continually borrowing at $4\frac{1}{2}$ per cent in order to buy bills at 4 per cent would speedily be in the Bankruptcy Court. The result of this is that while the Bank is prepared to help brokers in the last resort, it only does so at a stiff price, and no broker resorts to the Bank either for loans or discount unless all other sources fail him. To complete the story, every British bank by custom to-day pays interest on the ordinary deposit accounts opened by the public at a rate two points below Bank rate. Conversely, the

* During the early part of 1930, the three months' discount rate was consistently over a point below Bank rate. Thus brokers were earning less on their bills than their weekly loans from the clearing banks cost them. The circumstances, however, were abnormal, as at that time the Government were making special efforts to cut down the volume of Treasury bills. Hence there was an unusual shortage of bills.

ordinary loan made by a bank to a customer carries with it interest at a rate "one above Bank rate, minimum five". This means a rate always one point higher than Bank rate, except that when Bank rate falls below 4 per cent the rate on advances still remains at 5 per cent.

CHAPTER XVI

How the Bank of England exercises control—The weapon of the Bank rate—Open market policy—The Bank's policy and trade—The relation between gold reserves, money rates and trade—Effects of a rise in Bank rate.

It may seem that the Bank of England, by engaging itself to lend or discount without limit, is placing itself at the mercy of the market. In point of fact the position is exactly the opposite, for it is the Bank that controls the market, and indeed the whole course of business in the country. The reason is that the Bank of England is entirely free to fix interest rates where it thinks fit, as by raising Bank rate it raises the rates paid by the Joint-Stock Banks on their deposits, and also the rates charged by them for their advances to the general public and on their weekly loans to the money market. Again, if a joint-stock bank is paying a high rate on its deposits, it will require a higher discount rate when it buys its bills. Also if Bank rate is higher, the market rate of discount on bills has also a higher limit to which it can rise, and the result is that a rising Bank rate pulls up all other interest and discount rates, while a falling Bank rate forces them all down. The Bank thus gives the lead to everybody in the country who is either lending or borrowing money. As most of the trade and business of the country is conducted with borrowed money, whether through the medium of bills of exchange or bank loans, or indeed money lent or deposited by the general public, it is clear that a movement in Bank rate exercises a profound effect upon

- trade. If Bank rate rises, money is more expensive to borrow, and so a certain number of traders find that their margin of profit is less, and indeed that they have to reduce their commitments and pay off some of their debts. In short, a rise in
- Bank rate causes a falling-off of trade. Conversely, a reduction in Bank rate gives the "line clear" signal for trade to go
- ahead and expand. The Bank rate is thus one of the Bank
- of England's main weapons in the control of the general money situation.
- Modern experience has shown that Bank rate is a brutal
- and clumsy weapon, and in recent years the Bank has preferred to employ a subtler and more delicate instrument, much as if it had substituted a rapier for a bludgeon. This subtler weapon is called its "open market policy", often and paradoxically known as the "hidden hand". This weapon works in the following way: As part of its daily business, the Bank not only discounts bills at Bank rate on the market's initiative, but is continually buying and selling bills on its own initiative, while in addition it is continually buying and selling Consols, War Loan and other Government stock. Now supposing the Bank wishes to stiffen up rates a little and to impose a gentle restraint upon the financial world without resorting to the brutal method of raising the Bank rate. What it does is to sell a block of bills or Consols. The buyer pays for these with his cheque, drawn upon his particular joint-stock bank. The payment of this cheque automatically reduces the amount of the deposit held by that bank at the Bank of England. If the Bank of England sells £10,000 worth of War Loan to a customer of Barclay's bank, the payment of that cheque means that not only is the customer's deposit at Barclay's bank reduced by £10,000 but also that Barclay's deposit at the Bank of England is reduced by that amount. To replenish its cash holdings, the bank in question has to call some of its loans from the market. This produces a gentle stiffening of monetary conditions, and if the Bank of England continues its policy

sufficiently it can push loan rates and discount rates to such a point as it thinks fit. If Bank rate is $4\frac{1}{2}$ per cent, the Bank seems to like to keep market rate over $3\frac{1}{4}$ per cent. If market rate falls, say, to $3\frac{1}{4}$ per cent it can be expected that the Bank will start selling some of its stock and bills of exchange and go on doing so until it forces up market rate to the point it desires. Conversely, if the Bank wishes to make things easier, all it has to do is to buy War Loans or bills of exchange. This has exactly the reverse effect as that described above. This buying and selling of bills and stock on the Bank's initiative is known as the Bank exercising its "open market policy".*

Now what governs the Bank in its Bank rate or open market policy? The answer is, broadly, the state of trade in the country. If over-trading and speculation are rampant, the Bank thinks it its duty to take such steps as to stiffen up rates and bring the trading and speculating world to heel. If trade is slow and employment bad, the Bank will equally feel it its duty to make things as easy as it can. In addition to these broad considerations, the Bank has got to watch its own position, and in particular to see that its gold stocks are high enough in proportion to its liabilities. The Bank of England, it must be repeated, is subject to this obligation just as much as any other bank, and indeed to a still greater extent, simply because the strength of the Bank of England must be above suspicion. The result is that if the Bank is losing gold every day it will have to take steps to reduce its own liabilities. The best way to do this is to sell bills and stocks as part of its open market policy, for a reduction in the deposits of other banks at the Bank of England means a corresponding reduction in the Bank's own liabilities. If it raises Bank rate it equally strengthens its own position. It does so in two ways. Firstly, an increase in Bank rate pulls up trade and reduces the volume of credit outstanding. Bank

* But recent events have shown that occasionally market rate can pull down Bank rate!

notes return from circulation into the hands of the Bank, the demand for loans generally declines and the Bank can continue its open market policy of reducing its liabilities without placing too great a strain upon other banks. The second and more important result of an increase in Bank rate now comes into play. Whenever the Bank of England loses gold, it invariably loses it to foreign nations. (As has already been explained, measures have been taken to prevent gold leaving the Bank and getting into the hands of the British public.) This immediately introduces the question of foreign exchanges, which is dealt with in more detail in a later chapter, but it should be clear already that the higher interest rates generally are in London, the more will banks throughout the world be inclined to send money to London for employment. Now a rise in Bank rate pulls up with it all interest rates, not only interest paid and charged by banks, but also the rate of interest on stocks and shares. Therefore, the moment the Bank rate goes up there is a tendency for money to flow into London from all over the world, and it does not take long before this inflow of money is expressed in the form of an actual inflow of gold. Thus a rise in Bank rate not only enables the Bank to release its own liabilities but also stimulates a world gold movement in the direction of its own vaults. For a further consideration of these points the reader must await the chapter on foreign exchanges, and after he has read it he is advised to return to this chapter.

CHAPTER XVII

The foreign exchange market—Exchange rates—The par of exchange—
Gold points—How the market works—Bankers' foreign balances—
Dealers and brokers—The various kinds of rates.

THE Money Market is a market in loans and bills, *i.e.* in which money on the spot is exchanged for money due at some future date. There is another monetary market in London known as the Foreign Exchange Market. This is a market in which the monies of some other country are bought and sold in exchange for our own money. It can therefore be regarded as a market in which sterling is exchanged for money in some other place. The foreign exchanges really form a subject for a text-book in themselves, and no more is attempted here than to give a sufficient description of what is needed to fit them into the general scheme of this book. Such a description falls under three main headings, which form the answer to the following three questions:

- (1) What is it that is bought and sold?
- (2) How is it bought and sold?
- (3) Why is it bought and sold?

The answer to the first question is fairly simple. Broadly speaking, it is foreign monies that are bought and sold. The answer to this question, however, needs amplifying. What units are foreign monies dealt in? Thus eggs are bought by the dozen, potatoes by the bushel, meat by the lb. A similar rule has to be laid down for foreign currency in order to avoid confusion.

Now the fundamental measure of all money is the amount of gold a given unit of money contains. Thus the legal definition of a pound is that one lb.'s weight troy of gold $\frac{1}{1\frac{1}{2}}$ ths fine shall be worth £46:14:6, which means 1 oz. troy of standard gold is worth £3:17:10 $\frac{1}{2}$, and of fine gold just under £4:5:0. The sole basis of these ratios is that they are determined by the law of England.

In the same way American law says that a 10-dollar piece shall contain 258 grains of gold $\frac{9}{16}$ ths fine, and most other countries have similar laws defining the amount of gold their coins shall contain. By comparing these laws we can obtain the par of exchange between one currency and another. Thus the mint par of exchange between the British pound and the American dollar is \$4.866 = £1, and the reason why this is so is simply that there is as much fine gold in 4.866 dollars as there is in one pound. By exactly the same reasoning the mint par of exchange between the English £ and the German mark is Mks. 20.43 = £1, and so on for all currencies.

In normal times these pars form the basic price of the Foreign Exchange Market. For example, a man in need of dollars goes into the market and asks what is the price of dollars. Supposing he is told by a seller of dollars he can only get 2 dollars for his £, he will reply: "No, I can do better than that. I can go to the Bank of England and withdraw gold in 400-ounce bars, send them across to America, present them to the Treasury there and make the Treasury buy these bars from me in exchange for dollars; and if I do that, even when I have paid freight and insurance on my gold bars, and even after I have allowed for the fact that they are locked up in the strong room of the *Mauretania* for nearly one week and are earning no interest during that time, I shall find that for every £ I pay to the Bank of England this end I shall get back something like 4.84 $\frac{3}{4}$ dollars after meeting all my expenses. Therefore I will not accept your price of 2 dollars for £." The same thing can happen if a man who

wants to turn dollars into pounds was asked to pay 10 dollars for every £. He would reply that he could draw gold from America, ship it to England and sell it to the Bank of England, and in the end he would get £1 for every \$4.89 he paid.

This illustration raises one or two important questions. First of all it shows why it is that the price of foreign currency is governed by the par of exchange, and secondly, it introduces another fundamental rule of the Foreign Exchange Market, namely, that of the gold points.

The Foreign Exchange rates are in reality the prices at which currencies are being dealt in. When the rate on Paris is stated to be 124 fcs. to the £, it means that anyone paying down £1 in London will have 124 fcs. placed at his disposal in Paris. When the Bombay rate is stated to be 1s. 6d. per rupee, it means that anyone wanting rupees will have to pay 1s. 6d. for every rupee delivered to him. Some rates are quoted in so much foreign currency to the £, others in so many shillings and pence to the unit of foreign currency, just as some commodities are priced in so many shillings per lb., while others are priced at so many per shilling.

The normal price, as we have seen, is the par of exchange, but the current price is by no means always this normal price. When one pound sterling will buy less of a foreign currency than the quantity laid down by the par of exchange, the pound is said to be at a discount as against that currency, and that currency is said to be at a premium as against the pound. Or alternatively, exchange is said to have moved against England. Another but misleading way of talking is to say that the rate has fallen. The reason why the last expression is misleading is that supposing dollars fall from 4.85 to 4.84 dollars to the pound, it means that dollars have become more expensive, simply because at a lower rate you can obtain less dollars for the pound; therefore, while the expression suggests that dollars have fallen in value, as a matter of fact they have risen in value. In

general, all these loose ways of describing foreign exchange movements want interpreting with great care.

It is clear that the more people who want to buy dollars in exchange for pounds, the more expensive dollars will become, and the rate will fall from 4·86, first to 4·85 and then perhaps to 4·84 $\frac{3}{4}$. When it gets to 4·84 $\frac{3}{4}$ or thereabouts it will stop there, for the simple reason that it has reached what is called the lower gold point. The reason for this is that sooner than be content with less than that number of dollars in exchange for pounds, it will pay a prospective buyer of dollars to withdraw gold from the Bank of England, ship it to New York, and sell the gold to the United States Treasury in exchange for dollars. In the same way the more Americans there are who want to buy pounds the more expensive the pound will become, so that instead of getting £1 for 4·866 dollars they will have to pay 4·87, if not 4·88 and possibly 4·89 dollars, but about there the rate will now have reached the upper gold point at which it begins to pay America to send gold from New York to London. The only time when rates can move outside the gold points is when one or other country prohibits the export of gold, so that it is impossible to resort to the alternative expedient of sending gold, and anyone who must have dollars or pounds is at the mercy of the market. In short, the answer to the first question is that the Foreign Exchange Market deals in foreign currencies at such prices as it can get, but that these prices must be kept within narrow limits by the fact that foreign currencies are reduceible to one common denominator, namely, gold, and debts due from one country to another can, if other means become too expensive, be paid in gold.

The next question is, How does the market work? We have already seen that banks can hold deposits with each other. A bank not only keeps a balance with other banks in the same country, but keeps balances with other banks in every important country in the world. Thus a big English bank will have

a dollar balance with a bank in New York, a franc balance with a Paris bank, a mark balance with a German bank and so on, and all these American, French and German banks will have sterling balances with some bank in London. Thus if I want to buy dollars I can go down to my own bank in London, state my needs, and my bank will sell me dollars to be drawn from its own balance in New York. Again, if I have received dollars from someone in New York and want to turn them into pounds, I can equally take them to my bank and sell them to my banker, who will add them to his dollar balance in New York. Every big English bank is continually supplying or receiving dollars, marks or francs from other countries as part of its ordinary business. One man may come in and say he wants \$10,000 at once. The bank will sell him a telegraphic transfer, *i.e.* it will cable to its New York bank to pay \$10,000 out of its balance to the person designated by the customer of the bank. Another man may come in and say he wants a draft or cheque for 20,000 fcs. The bank will draw a cheque on its Paris balance and hand it to the customer, who will post it to his creditor in France. Another man may come in with a cheque, say, for \$10,000 which he wishes the bank to credit to his own account. Here the bank will ask him whether he is handing over the cheque for purchase or collection. If for purchase, the bank buys the cheque from the customer on the spot and credits his account with the sterling equivalent. If for collection, the bank sends the cheque out to his New York agent, who presents it to the paying bank, collects the proceeds in dollars and advises the London bank accordingly. Then and only then does the customer's account get credited. Thus, if he wants his money quickly, he must sell his cheque to the bank, but naturally he will not get so much paid into his own account as if he had handed in his cheque for collection.

It is clear from the above description that London bankers' foreign balances are continually rising and falling as a result of these operations, and sooner or later a bank will find either

that its New York balance has run dangerously low or that it is getting far bigger than it needs. This is where the Foreign Exchange Market comes in. This market is simply a market between the various banks with the object of enabling those banks which are short of dollars and other foreign currencies to buy from other banks who may have too many. It is a market in which business is transacted almost entirely by telephone, each bank's dealer operating from his own desk in his own office. To facilitate business the market includes agents known as foreign exchange brokers. A broker's business is not to buy and sell foreign exchange on his own account. What he does is to keep the various banks in touch with each other and in touch with current rates. Thus a bank wanting to buy dollars will get in touch with the particular broker who specialises in dollars, and then the broker will try to find a bank that is a seller. Also when, as often happens, a broker finds a buyer and seller with different ideas about the proper price to be paid, he will quote various prices to both of them and try to find one on which they can both agree.

The rates quoted each day in the Foreign Exchange are the rates at which business is done in the market proper between the different banks, and the rate at which a bank will buy or sell dollars or francs for his customers is governed by the market rate of the day. The banker adds a small charge representing the cost of doing the customer's business and his own profit. Thus a customer instructing a banker to mail \$5 to New York will be charged the sterling equivalent of \$5 at the day's rate plus, say, 1s. charges.

As banks deal with each other in cable or telegraphic transfers, the quoted rate is often called the cable rate, which means that both buying and selling banks instruct their foreign agents by cable to transfer the dollars from one balance to the other. By custom in the market the dollars have to be paid for within two or three days. The customer, of course, is not bound to buy a cable transfer from his bank.

He can buy or sell a cheque, or even actual currency such as dollar notes. He can even sell to his bank a bill of exchange drawn in dollars or francs or in other currency, payable not at once but in two or three months' time. In this last case, of course, the bank will not buy a dollar bill at its full face value, but just like an ordinary English or sterling bill, it will deduct from its price the rate of discount applicable to that class of paper, *i.e.* if a bank takes dollar bills from a customer it will not pay £1 for \$4.866 payable in three months, but will want a bill for \$4.91 if it is to pay £1. Similarly, an American banker buying a sterling bill for pounds payable in three months will not pay for it \$4.866 but will only pay \$4.83, and of course, the worse the bill the wider the rate is from the par of exchange. In short, the Foreign Exchange Market proper is a market between the banks existing with the object of enabling each bank to maintain its foreign balances at a proper level. The ordinary individual does not deal directly in the Foreign Exchange Market, but buys and sells through his own bank.

One form of foreign exchange needs rather more detailed explanation. This is forward exchange. Just as traders often buy and sell futures in cotton or grain or other commodities, so as to guard themselves against losses from adverse price movements, so do those having transactions with foreign countries need to guard themselves against adverse exchange movements.

For example, an Englishman lending money in the New York market has to buy dollars to make the loan and has to turn his dollars back into pounds—*i.e.* sell dollars—when the loan is repaid. Now suppose he buys his dollars at \$4.84, and three months later, when he is repaid, the rate is \$4.88. For every £100 he puts into New York he will only get $\frac{4.84}{4.88} \cdot 100$, or £99 : 4s., out. A loss of 16s. per cent in three months equals $3\frac{1}{2}$ per cent per annum, which will make a big hole in the interest earned on the loan.

So the prospective lender, when he buys his dollars, at the same time sells the same number of dollars "three months forward", that is for delivery in three months' time. And he sells at the three months' forward rate of the day, which is quoted daily like other rates, and rarely varies much from the day's spot rate. Say it is $\frac{3}{8}$ of a cent "discount" or "above spot", that is if spot dollars are \$4.84 three months' dollars are \$4.84 $\frac{3}{8}$. Then by selling dollars forward he limits his loss on exchange to 1s. 7 $\frac{1}{2}$ d. per £100 on the three months' loan, equivalent to only $\frac{5}{16}$ per cent per annum.

There is always an active forward market in the chief foreign currencies, with sufficient buyers and sellers to ensure that everyone's needs are met; and the banks too deal in forward exchange between each other, so as to keep their books level. Rates are always quoted so much "above" or "below" spot, and their exact relation to spot depends on supply and demand. Usually if a particular centre is offering high rates for short loans, its forward rates will be at a discount or above spot. The reason is that the centre is attracting a large number of foreign lenders, all of whom are buying spot and selling forward exchange, as explained above. Thus spot exchange becomes dear and forward exchange cheap.

Immediately after the war, when gold shipments were suspended and exchange rates moved without limit, forward dealings were a protection against very heavy losses. To-day the risk is minimised, but even so, the measure of protection afforded by forward cover is worth obtaining.

CHAPTER XVIII

Foreign payments—Trade—Capital—Interest—The balance of payments—
Gold shipments and their effect—Why dearer money rectifies the
exchanges—Some recent examples—Triangular payments.

WE come now to the last question—why foreign exchange is bought and sold. The answer is a simple one. An Englishman buys dollars because he wants them, just as a Frenchman buys pounds because he wants them; and the Englishman wants dollars because he has money to pay to someone in America who wants to be paid in dollars. The reasons why he pays dollars to somebody in America are just the same and as many as the reasons why everyone at intervals pays over money to his friends, tradesmen, customers, business connections and so on.

They can be divided into three main classes:

(1) Payment for goods and services. An Englishman buying and importing anything from America, whether it is a bale of cotton, a sack of wheat or a Ford car, has to pay dollars. An Englishman hiring space in an American ship has to pay in dollars. An Englishman travelling in America has to pay his hotel bill, railway fare, etc., in dollars. An Englishman employing an American broker, banker, solicitor or anybody as his agent in America has to pay the usual fee in dollars. In the same way an American buying English goods, using English ships or employing English agents has to pay them in pounds. We speak of these as the import and export of goods and services. The import and export of goods is known as visible trade; the import and export of services is known as invisible trade.

(2) The next class deals with movements of capital. A man investing some of his money in American stocks and shares has to buy dollars in order to pay for the shares he buys. The English government, repaying the American debt, equally has to buy dollars in order to make the repayment. An American selling, say, a block of English War Loan makes the broker who sells the stock for him buy dollars in order to pay over to him the proceeds. Should the American government float a sterling loan in London, the Issuing House responsible for the loan would have to buy dollars in order to remit the proceeds to the American government, and while the American government under present conditions would be the last to raise a loan in London, other governments and municipalities frequently do, and each such loan means the exchange of sterling for the appropriate foreign currency. All these transactions are known as the import and export of capital. The test as to whether it is import or export is this. Where sterling has to be sold and foreign currencies bought to carry out the transaction, then it is export—and vice versa. The names thus are reversed as compared with the import and export of goods and services.

(3) Finally comes interest movements. British capital invested abroad earns interest, which has to be paid to the holder of the stock in sterling. Thus all interest on British capital overseas demands for its payment the purchase of sterling. Conversely, all dividends paid by British companies on shares owned by foreigners demand a sale of sterling and the purchase of the appropriate foreign currency. Interest receipts from overseas are usually classed with other invisible exports, just as interest payments to overseas are called invisible imports.

Now, obviously, if all these transactions should balance out so that in the aggregate as much sterling has been sold for some purpose as has been bought for other purposes, clearly the Foreign Exchange Market will float on an even keel, for the demand for foreign currencies will equal their

supply, and consequently rates will remain around par. But suppose, for example, Great Britain's imports of goods and services plus her export of foreign capital should exceed her exports of goods and services and her import of foreign capital, clearly, then, there will be more people trying to sell sterling than wish to buy it, and exchange rates will, in the language of the market, move against London, *i.e.* dollars, francs, marks, etc., will all become dearer than their par value; eventually one or more of these rates will reach the gold point defined above, and banks, sooner than pay the high rates quoted in the Foreign Exchange Market, will draw gold from the Bank of England and ship it abroad. If these gold shipments go on for more than a short time, action will have to be taken.

Now, as explained in a previous chapter, when the Bank of England was losing gold it took steps to reduce the supply of money and also to raise its discount rate, namely, the Bank rate, and pull up other interest rates with it. It is now possible to put the whole financial mechanism together and see exactly how it works. Take, first, the import and export of goods. Clearly, if British prices are above the world-level, then British goods will be too dear for the world to buy and foreign goods will be so cheap as to be worth buying and importing into England. Now, one of the first effects of making money less plentiful by raising interest rates and restricting credit is to force down the British price-level. Hence British goods will become cheaper and the world will buy more of them; and by an application of the theory of relativity foreign goods will seem dearer and so England will buy less of them. So one of the first effects of the measures taken to counteract gold losses is to stimulate exports and to discourage imports. This reduces the demand for foreign currencies and increases the demand for sterling, and so helps to rectify adverse foreign exchanges. To put it in a nutshell, everybody tries to buy in the cheapest market, so that if prices are reduced in England more people come to buy in England

and Englishmen have a dearer market to buy in abroad. But that is not the whole of the story. We now come to the effects of tighter and dearer money upon the import and export of capital. Every investor naturally tries to lend his money in the place where, granted an adequate measure of safety, he can earn the biggest interest. Conversely, every borrower naturally goes to the centre where he can borrow cheapest. The result, therefore, of higher interest rates in London is to encourage the foreign investor to buy British stocks and shares and to discourage the foreign borrower from coming to London for his needs. Thus the export of capital is reduced and the import of capital increased. This again relieves the pressure upon the foreign exchanges. The whole mechanism, therefore, should be purely automatic. Cheap money means high prices at home and therefore excessive imports of foreign goods; it also means a rush of foreign borrowers to the home market. Both of these factors mean adverse foreign exchanges and gold losses. The moment money is made dearer and scarcer, home prices fall, imports are replaced by exports, the foreign borrower is frightened away and the foreign investor takes his place. Normally this is enough to create the counter-demand for the home currency that is needed.

One or two examples of recent history can be given by way of illustration. First of all, it is common knowledge that the American exchange moves against London every autumn. The reason is that in the autumn American crops of cotton and grain are shipped to Europe. These have to be paid for in dollars, and as London is the world's money centre, the London Foreign Exchange Market and the British pound have the task of paying not only for our own cotton and grain but also for that sent to other European countries as well. All this means a particularly large demand for dollars, and that is why the dollar rate at that time falls below par.

During most of 1928 and 1929 the dollar was consistently

worth more than its par value in sterling. The reason was that there was a Stock Exchange boom in New York. Everybody was borrowing money in order to take part in the boom, and interest rates consequently ran very high in New York. This made New York a desirable centre to lend money in, and many European financial institutions poured a lot of their money into New York. All this meant a special demand for dollars, and so dollars became dearer. In the autumn of 1929 the boom broke. People got frightened, and promptly took their money away from New York. The exchange at once moved in favour of sterling, and the Bank of England, which previously had raised its rate to stop the exchange going against the pound, at once lowered it. To conclude with a third and more complicated example. The German rate at one time fell below its par value as against sterling, in other words marks became expensive, so much so that gold was sent from London to Berlin. The reason was that London wanted dollars in order to pay for American cotton and grain. The French had dollars they did not want, so they sold them to London. London paid for those dollars in sterling, and Berlin at that time being a centre where interest rates ran high, France proceeded to lend the sterling in Berlin. Berlin, of course, wanted the money that was lent to be turned into marks, so the French sold the sterling in exchange for marks and so raised the value of the mark against the pound above its par level. So far as London was concerned the shipment of gold to Berlin was virtually a shipment of gold to America to pay for American cotton and grain.

This last example is a good one, illustrating the fact that international money movements are more often of a triangular than of a direct nature.

CHAPTER XIX

Interest—Lending and saving—Reasons for saving—Why interest is paid
—The risk element—The time element—The two kinds of borrowers—
The rate of interest.

THE last few chapters have been concerned mainly with the medium of exchange, namely, money in all its shapes and forms. We have seen of what it consists, how it comes into existence, how it is dealt in, and how in general the amount in existence is governed and kept under official control, partly by natural forces and partly by the separate actions of those responsible. It is now necessary to turn from considering money solely by itself and to link it up more closely with our general lives.

All the way through the preceding chapters we have discussed various rates of interest and discount without considering why, fundamentally, there should be such a thing as a rate of interest at all. It is now perhaps advisable to deal with this point. The lender is able to obtain interest on the money he lends solely because the borrower is willing to pay him, and the rate of interest depends on the extent to which the lender desires to lend and to the extent to which the borrower is prepared to pay interest or go without his loan. Now, before the would-be lender can lend money, he must have the money to lend, *i.e.* he must have in his possession money which he has acquired by fair means or by foul and which he does not desire to spend at the moment. That is to say, lending implies, in the first place, the act of saving, using the word in the simplest sense of the term

of having money to spend and refraining from spending it at once.

Now, most of us have to save money, to provide for the emergencies of life, such as sickness, death, old age and for one's children. Even if interest were illegal we would very rarely keep our savings in the form of coin at home because of the risk of fire, thieves and other chances. Rather than this the first thing we do is to pay it into our banks, and, as has already been shown, a deposit in a bank is in reality a loan by a customer to his banker. It has further been shown that such deposits do not always have interest paid upon them by the banker. In many cases the lender prefers to have the power of withdrawing his money on demand rather than to leave it on a time deposit earning interest. In this way a fairly large sum of money in the aggregate is saved every year and lent to the banks without earning any interest at all. The power to earn interest on our savings is not the only force that impels us to save.

Nevertheless, it is common knowledge that the bulk of the money saved by the people of this country is invested, *i.e.* lent or employed in such a way as to earn interest. The reason is that there is a far greater need for loans and the temporary use of other people's money than can be satisfied by this minimum of savings without interest. Again, those who entrust their savings to other people run on an average a greater risk than those who keep their savings locked up at home and not on deposit at their bank, and the risk varies with the probity of the people to whom the savings are entrusted and the uses to which they are put. Finally, the man who has his savings locked up in his own house or deposited at any bank can realise them and spend them at a week's notice at the most. On the other hand, most people who borrow money want it for a definite, and often a long period of time, and when a loan is made the lender agrees not to seek to recover his money until the time has elapsed.

Interest, therefore, rises from three main causes: Firstly,

the demand for loans; secondly, the risk involved in making loans; and thirdly, the fact that when a loan is made, usually the lender parts with the right to use his savings for a definite period.

Now, who is it, as a broad rule, wants to borrow money? Borrowers form two classes. Firstly, the people who have spent more than they have earned and want to borrow to fill the gap. In this group falls the individual who, if wise, goes to his bank, and if foolish, goes to a moneylender for temporary accommodation; the business or the company which, in order to meet temporary losses, finds it necessary to raise a loan either from the bank or by the issue of debentures. It even includes the country whose ministers have spent more money than the national revenue brings in. There is, fundamentally, no difference between the National Debt of a country and the debts incurred by private citizens. The other group of people consists of those who wish to undertake a new business venture or to extend an old one, and find that the capital or money needed to launch the venture is more than they can put up themselves. They therefore borrow, not because they have already run into debt, but because they believe that the return they will gain from their venture will exceed the interest they will have to pay on the money they borrow. Whether they are right or wrong time alone will show them and the people who entrust them with their money.

At the back of the whole question of interest is clearly the time element. The fact that a man has money to lend means that for one reason or another he has an immediate claim upon the community to provide him with a certain amount of goods and services. When he lends his money he forgoes that claim, and only recovers it if and when the borrower repays him. Up to a point we have seen that he may well prefer to postpone that claim until some date when he may really need it to use against an emergency, but beyond that point, and remembering the fact that he may never recover

the claim at all if the borrower fails to repay him, he can clearly justify himself in exacting from the borrower a certain compensation in return for his deliberately consenting to forgo his claim for the goods and services he needs.

The exact rate of interest he should demand depends on many factors. In the vast number of cases it is determined by supply and demand, for money has its price just as every other commodity, and the price is fixed according to the same broad principles, but, clearly, the lender must not extort a rate of interest greater than that which it is fair and reasonable to demand. In certain cases the law of the land steps in to control the rates at which money may be lent.

CHAPTER XX

The employment of savings—Bringing lenders and borrowers together—
The limited company—Its two great principles—Associated effort
—Limited liability—Its justification—The structure of a company—
The various kinds of shares—Their underlying principles—Possible
abuses—Share denominations and dividends—No par value shares.

WE have seen that in order to obtain the goods and services we need in exchange for those we are able and willing to produce, we want not only a medium of exchange but also a means of exchange, under which last definition is included every kind of market. A means of exchange is clearly necessary in the case of lending and borrowing. One such means of exchange, namely, the Money Market, has already been dealt with. But quite apart from this narrow sphere, the man who has savings to invest must have a ready means of getting into touch with people who need his money for their own uses.

There are various markets for this purpose in existence. For example, when the Issuing House, described in a previous chapter, publishes an advertisement inviting all and sundry to subscribe to a new loan to a foreign government or anyone else, it clearly is, by invitation, providing a market, *i.e.* a means of bringing a borrower into touch with numerous lenders. The British Government, when it offers Savings Certificates at every Post Office in the country, is using the Post Office as a shop for bringing borrower and lender together just as much as, normally, the Post Office is a shop which sells the right to send letters, telegrams, etc. The Building Society acts as a merchant or a middleman in the

truest sense of the word. On the one side it invites people who have money to invest to invest it with them, and on the other hand it announces to people who want to borrow in order to pay for their houses that it is ready to lend to them, and what the rate of interest on the loan will be. A bank is clearly another such middleman, though a middleman who borrows and lends within certain well-prescribed limits. Over and above all these there is one great market for lending and borrowing, and that is the Stock Exchange.

During the last 100 years there has been a great development whereby people who are strangers to each other are enabled to join together to invest their savings in a common enterprise. This consists of the formation of a Company. Two great principles of a modern company are the principles of associated effort and of limited liability. Associated effort is by no means peculiar to a company engaged in trade or business. Every club, every society and every association, whether social, political or for any other purpose, is an example of associated effort. They all have this much in common, that the original members agree to draw up certain rules to govern their conduct towards each other when engaged in their common enterprise, and also appoint certain of their number to carry out the work needed for the proper conduct of their society. There is fundamentally no difference between the Board of Directors of a big bank or railway company, the Council of a famous learned society, and the committee of a suburban tennis club. The only difference is one of degree and nomenclature. Where a society speaks of its object, a company will speak of its memorandum of association, this being the document that inaugurates a company and lays down the activities in which it is going to engage. Similarly, where a society speaks of its constitution or rules, a company speaks of its articles of association, this being the document that defines the way in which it shall conduct its business, appoint its directors, and so on. The only difference between a society and a company is that as the latter

enjoys certain privileges under law, so in certain circumstances where it wishes to alter its articles of association it must go to the Law Courts for leave to do so, even after its own members have agreed upon the alteration.

— The great principle of limited liability is peculiar to a company only. When a company is formed, those responsible for its formation agree that it shall have a certain capital, and the capital decided upon is definitely stated in the memorandum of association. The capital is divided into a determined number of shares and these shares are either taken by the promoters themselves or offered to their friends and also to the general public. Everybody taking up shares has to pay so much for each share.* He may not have to pay it all at once, *e.g.* the full price of a share may be £1, but only 5s. is paid up to begin with and the remaining 15s. is only called up at some later date or at times not at all. But whether the whole £ is called up at once or not, the principle of limited liability lays down that the purchaser of a £1 share can under no circumstances be called upon to pay up more than £1. Even if the company goes bankrupt, even if it is fraudulently and criminally managed by its directors, once the subscribed capital of the company is gone, the unfortunate creditors of the company can get nothing more.

A moment's thought will show the justification of this rule. To look at it first from the other end, few people are going to be rash enough to become shareholders in a company along with a host of people they have never heard of, if by so doing they are rendering themselves liable to the extent of their whole property if things go wrong with the company. The City of Glasgow Bank failure some fifty years ago involved countless people in ruin of this kind. In other words, were it not for the principle of limited liability the vast majority of people who had savings would not venture them in enterprises for the good of the whole world as well as themselves, but instead would hoard them at home. Thus

* For example, see pp. 105 *seq.*

the principle of limited liability has done more than anything else to mobilise the world's savings for the furtherance of industrial activity to the benefit of all. Next, as regards the unfortunate creditor, as we have termed him, when he allowed the company to run into his debt he did it, or should have done it, with his eyes open. He knew that the company's liability was limited, and he knew, too, that the law provides that in return for this privilege of limited liability, the company has to publish its balance-sheet each year showing the whole world exactly where it stands. In other words, if the creditor likes to take the risk, he only has himself to thank if things go wrong.

Shares in a company are of various kinds. First there may be preference shares. These have a prior claim upon such of the profits earned each year by the company's business as the directors decide to distribute, and in the event of the company being wound up, *i.e.* brought to an end, and the assets distributed, preference shareholders' claims must be settled ahead of those of other shareholders. In return for this prior consideration both as regards profits and capital, preference shares as a rule are subject to a limited dividend, *e.g.* a 6 per cent preference share would only get each year a maximum dividend of 6 per cent on the normal value of the share, and all other profits would go to other classes of shareholders. Very often the preference dividend is cumulative, *i.e.* if in one year the company does not earn enough even to pay the preference dividends, next year all the preference dividends in arrears have to be paid off and also the current year's dividend before the ordinary shareholders can get anything. At times preference shares are participating, *i.e.* in addition to their fixed dividend they also get a defined share of any surplus profits.

All these questions, of course, are defined in the company's articles of association, so that anybody acquiring preference shares knows from the start exactly what rights he possesses. Ordinary shareholders have to wait their turn

for their dividends, after preference shareholders' claims have been satisfied, but whereas the preference dividend is usually only a fixed amount, the ordinary shareholders get what is left, which may be anything—perhaps nothing at all, or perhaps very much indeed.

Occasionally a company will have deferred shares. These in turn rank after the ordinary shares, and in this case the ordinary shareholder only gets a certain amount, and it is the deferred shareholder who gets what is left. There are other kinds of shares, but the differences between them and those already described are mainly differences of detail, so much so that it is often necessary to examine the structure of the share capital of any company separately.

It is clear, however, that there is one guiding principle. This is—and it is not peculiar to shareholders in companies—the greater the risk, the greater the prize. Unfortunately, this principle, like all other principles, is at times abused, and there have been many instances of companies where the ordinary or deferred shareholders get a big prize when things are going well, and manage to pass on an unfair share of the risk to the preference shareholders when things are going badly. Say a company had a preference share capital of £500,000 and an ordinary share capital of only £50,000. It is provided that if the company is wound up the preference shareholders must have their claims satisfied first. Yet this privilege with such a company is entirely illusory. The company started with a total capital of £550,000. Only $\frac{1}{11}$ th part of this has to disappear to put the ordinary shareholder out of it altogether, and any further loss that occurs at once falls upon the preference shareholder. On the other hand, when things are going well the company may well earn profits which, after paying 5 per cent in regard to the preference shares, may leave enough over to permit of a dividend of 10, 20 or even 40 per cent upon the ordinary share capital.

It is laid down by law in England that shares should have

a definite nominal value. If a company's capital is divided into, say, 50,000 shares it must be divided into 50,000 shares of a given denomination, say of 10s. or £1 each. This rule is in one sense convenient, for when the directors each year decide what sum out of the year's profits each share shall receive, they can "declare a dividend" of, say, 5 or 10 per cent and then each holder of a £1 share knows that he will obtain 1s. or 2s. as his share of the year's profits. This procedure, although convenient, is not essential. The directors can perfectly well, and frequently do, declare a dividend, not of 5 or 10 per cent, but of 1s. or 2s. a share. Apart from this there are many grounds for regarding the need to attach to each share a definite denomination as being misleading. For example, when a company makes an issue of £1 shares it is not necessary to sell them to subscribers at £1 each. It very frequently sells them at 25s. or 30s. each. As we shall see when dealing with the purchase and sale of shares on the Stock Exchange, the fact that a share is of a denomination of £1 does not mean that you will get £1 for it when you sell it, or that you will not have to pay more than £1 for it when you buy it. Over and above all this the fundamental consideration of a company is that of the share. If you get a dividend of 2s. on your £1 share, when that share is one of 50,000, the true way to look at it is not that you are getting a dividend of 10 per cent on the nominal value of your share, but that you are getting $\frac{1}{50,000}$ part of the total of the year's profits which the directors decide to distribute to the shareholders. For that reason there is much to be said in favour of the American system for issuing shares of no par value. Under the British system a £1 share has a definite but largely meaningless par value of £1. The Americans, by refusing to give a share any par value at all and by looking at it as representing a definite share of the company's assets, business, profits and prospects, have got far nearer the real principle. The chief thing that can be said in favour of the British system is

that the act of giving a par value to a share sets up a kind of warning post to the shareholders to remind them in case of need that the actual value of the share has fallen below par. The American shareholder has to work out his warning signal for himself.

CHAPTER XXI

Stock—Debentures—Safety and interest rates—The long-term element—
Why capital must be realisable—The need for a market.

SOME companies, instead of having a capital in the form of shares, have it in the form of stock. The difference is mainly one of practice and nomenclature. The price of stock is quoted as so much cash per £100 of stock, whereas the price of a share is quoted as so much per share. Dividends on stock are always expressed in the form of so much per cent, *i.e.* a dividend of 5 per cent shows that the holder of £100 of stock in a company receives a dividend of £5. Where a company's capital consists of, say, £100,000 of stock the owner of £100 stock must look at his holding as representing $\frac{1}{1000}$ part of the company's capital in exactly the same way as he would if the company's capital consisted of shares.

In addition to their stock or share capital, which takes the various forms described above, many companies also issue debentures which almost always take the form of stock. A debenture is fundamentally a loan to the company by the debenture holder, and as a company like everybody else has to pay its debts up to the limit of its liability before it can distribute its profits, therefore interest on debentures has to be paid before the dividends on the share capital. In law, the company that fails to pay its debenture interest has committed an act of bankruptcy, and the debenture holders can claim that the company be wound up and its assets distributed to the creditors, leaving the shareholders only what is left over. If a company fails to pay preference or ordinary

dividends it is clearly not committing an act of bankruptcy, for the company and its shareholders are in a sense identical and nobody can be declared bankrupt for failing to earn profits and distributing them to himself. It is thus clear that just as the preference shareholder ranks above the ordinary shareholder, so does the debenture holder rank above all shareholders, *i.e.* he has the greatest margin of safety, and therefore he will as a rule be content with a lower rate of interest on his debentures than the preference shareholder will require on his shares. That is why many companies prefer to obtain fresh capital in the form of debentures rather than by a further issue of shares. At times, it is true that debentures can only be issued at a high rate of interest. This is due to one of two causes. The first is that at the time of issue all interest rates may be high, and the second is that the company is in Queer Street and is issuing debentures not so much because it needs more money to extend its activities as that it needs more money in order to pull itself out of its troubles. In such a case the debenture holder knows that he runs a fair amount of risk, and he wants, quite rightly, the corresponding reward.

When a man invests his money in a company by buying shares in it he has clearly committed his money to the company for so long as it remains in existence, and he cannot go to the company and demand his money back. Even when he buys debentures, they are usually not repayable for a long term of years and in some cases are irredeemable, *i.e.* the company only has to pay the interest to him each year and is never bound to repay the principal at all. Again, governments and municipalities issue loans to which the public subscribe, and these loans again are either irredeemable or only repayable at the end of a long time. Thus British Government $2\frac{1}{2}$ per cent consols can only be redeemed if the government so decides; 5 per cent War Loan can be redeemed now if the government wishes, but the government is not bound to redeem it until 1947; and other government

and municipal stocks are also usually repayable at distant dates. The fundamental principle is that whatever stocks and shares the investor buys he cannot get his money back from people issuing those stocks and shares except at such dates as the issuer has fixed, and which may be very far distant. Now, clearly, if a man can only invest his money at the cost of locking it up over long periods, which in many cases exceed the length of his own life, he would be very chary about investing his money at all. It is necessary to repeat once more the fact that investing is the result of saving, and more often than not a man saves money for use in times of emergency or in his old age. Hence, for savings to be available for use in trade and industry, more is needed than the machinery of the company. A man must not only have the means of combining with his fellows in a common enterprise, but must also have the means of withdrawing if circumstances render it necessary. On the other hand, the man who has money to invest may find that at the time he wanted to make his investment no new companies are being formed and no new government or corporation loans are being issued, that, in other words, he has not the opportunity for investment that he desires. The solution to this problem clearly lies in the establishment of a market where the man who wants to withdraw his money from the company in which he has invested it can sell his shares to the man who wants to invest his money and is looking for an opportunity. It is the function of the London and other Stock Exchanges to provide this market. The Stock Exchange, in short, is a market in which stocks and shares are bought and sold at prices agreed upon by buyer and seller.

CHAPTER XXII

The Stock Exchange—Brokers and jobbers—The jobber's turn—His function—The fortnightly account—Contangos—Factors governing prices—Yield and prices—Prices and prospects—Bonuses—Rumours—Speculation—Its advantages and abuses.

THE London Stock Exchange is a closed market and only members, who have to conform to the rules laid down by the Committee of the Stock Exchange, are allowed to deal in it. Members of the Stock Exchange fall into two classes, brokers and jobbers. The broker acts as the agent of the public. If a man wishes to buy stocks or shares he goes to his broker and gives him the order, usually stating the price limits within which the order must be executed if possible. The broker then has to do the best he can, but occasionally a client will tell his broker to buy or sell "at best", and this means that the broker has a free hand as to price. The broker works on a scale of commissions laid down by the Committee of the Stock Exchange, and it is from these commissions that he pays his expenses and earns his profit. The jobber, on the other hand, never comes into contact with the public. He only deals with brokers, and brokers never deal direct with each other. If a broker has an order from a client to buy, say, £1000 of Great Western Railway ordinary stock, he goes to one of the jobbers who specialise in railway stock and asks him what the price of Great Westerns are. The jobber immediately quotes two prices, say, £85 to £86. That means that if the jobber is going to be asked to sell stock to the broker his price is £86, but if the broker is the seller, the

jobber will only pay £85. It is from this difference or "turn" that the jobber makes his living. When the jobber names his price he engages to fulfil such order, either purchase or sell as the broker chooses, and it is the jobber's business to see to it that his purchases for the day approximately equal his sales. Of course, if he finds purchases are outrunning sales he immediately raises his price, and vice versa, for the broker, if he does not like the jobber's price, is not bound to deal. It may seem that the stock jobber is an unnecessary middleman, but he is not really so. Without the jobber who is known to specialise in certain stocks the broker would have a very difficult task, going all round the Stock Exchange in order to find another broker who wanted to sell what he himself wanted to buy and in the same quantities. Again, purchases and sales of a particular stock on a particular day do not necessarily balance completely, and here the jobber comes in and takes up what slack occurs.

The custom of the London Stock Exchange is to settle all bargains fortnightly, and every other Thursday is known as settling day. On this day all members of the public who have bought stock have to pay their brokers for it, and all members of the public who have sold stock have to deliver it to their brokers, and the brokers and the jobbers similarly settle between themselves. Occasionally, however, a member of the public will wish to "carry over" a transaction from one fortnightly account period to the next, that is, to defer settlement until the next settling day. If so, the client first of all either pays to or receives from his broker the difference between the price at which the stock was originally bought and the final price of the stock, known as the making-up price, declared at the end of the account. Secondly, a client, by postponing payment for a fortnight, is in fact borrowing the sum at issue from his broker, and the broker has to borrow in his turn. Hence the broker charges his client a rate of interest known as "contango". This rate is fixed at the end of each account for each particular stock, and is governed

by a variety of considerations, such as the general level of interest rates and the general demand for contango facilities in respect of the particular stock. In the same way, a client who has sold stock and wishes to carry over delivery to the next account may be charged a rate called "backwardation".

The above is a very brief description of the working of the Stock Exchange. The next point is what fixes the price of stocks and shares. Prices on the Stock Exchange are fixed in exactly the same way as prices in every other market, *i.e.* they have to be prices which are acceptable at the moment to buyers and sellers. Thus, up to a point the money side of the price equation holds equally as regards stocks and shares as it does with regard to cotton, wool, etc. In practice, however, the money side of the equation is of comparatively minor importance in the stock markets. Most of the factors which affect Stock Exchange prices arise from the intrinsic character of stocks and shares themselves.

Broadly speaking, there are two sets of considerations. The first is the rate of interest or dividend upon a particular stock or share; the next is—is it likely to decrease or increase in value? As regards interest or dividends, here the general level of interest rates is obviously the governing factor. A man knows that if he puts money on deposit at his bank he will get a certain defined interest and complete security, and, in particular, he knows that he can get his money out of a bank at a week's notice—a pound out for every pound he put in. Once he buys stocks, even if they are high-class British Government stocks, there is no guarantee that he is going to get pound for pound out of it. What he will get will depend on the price current on the day he sells, and while he may get more out, he may get less. Hence it is natural that he should require a higher interest on stocks and shares than he can get at his bank, and it is also natural that if the interest on bank deposits, and indeed the return on bills of exchange, varies, so the interest required on stocks and shares also varies. Now, how is it that the

interest varies on a stock bearing a fixed rate of, say, 5 per cent? The answer is that if you succeed in buying £100 worth of 5 per cent stock for £80, the interest you get is not £5 on £100 but £5 on the £80 you put in, *i.e.* a rate of $6\frac{1}{4}$ per cent. On the other hand, if you pay £120 for £100 of 5 per cent stock, you only get £5 interest on the £120 you pay in, which is equivalent to $4\frac{1}{6}$ per cent. In short, the higher the price of the stock, the lower the effective interest or yield. Hence it is natural that when interest rates are high prices of stocks and shares should be low.

The case of ordinary shares and even the preference shares in a company is more complicated. The dividend on ordinary shares is not fixed. It depends on how well the company is doing, how big profits it earns and how much of these profits the directors decide to distribute in dividends. Even in the case of preference shares there is always the chance that the dividends may not be paid if the company is doing badly. Moreover, when a company is doing very well the shareholders come in for various windfalls. The company may need extra capital and may offer to the shareholders fresh shares at, say, the price of £1 each, when the Stock Exchange price of existing shares is £2.* That in effect is putting £1 into the pockets of the shareholders for every share held. The company occasionally issues bonus shares for nothing, *i.e.* it may have a capital of £100,000 and a reserve fund of £50,000, and says to the shareholders: "We will turn the reserve fund into capital by giving you one share free, gratis and for nothing, for every two shares you hold". By doing this they will, of course, abolish the company's reserve fund and increase the capital to £150,000. All shareholders should incidentally notice that this is a mere matter of book-keeping, and the company's assets are not increased by that operation, neither are their profits and earning power.† In other words, unless the directors are able

* See p. 182 for an example.

† For example, see p. 181.

and willing to distribute more in the form of dividends, the fact that the shareholders receive the extra share for every two they hold does not necessarily mean that they get more money in dividends at the end of each year. Even so, the distribution of bonus shares is usually regarded as a sign that the company is doing well, and so makes people inclined to bid for the company's shares.

Now all these chances and changes naturally affect the price of shares. Normally speaking, it would be natural that the price of an ordinary share should give a yield greater than preference shares, and considerably greater than high-class stocks such as Consols or War Loan.

The reason for this is the old rule that the greater the risk to the holder the greater the yield he requires on his holding. But people buy and sell shares not only because of the yield at the moment but also because of what they rightly or wrongly think is going to happen to the company in the future. The rumour that a company is doing badly, that there will be no dividends at the end of the year, will depress the price of these shares right out of proportion to the latest dividend and the general level of interest rates. Equally, a rumour that a company is doing very well, that its shareholders are to receive some kind of windfall, or that the dividend is going to be increased, will cause the price of these shares to be run up until, based on its latest dividends, the yield will be only 2 or 3 per cent. The final arbitrator in every case is the yield on the share, but as a rule it is swayed by rumours, anticipations and the general fallibility of human nature.

It is clear that in a market subject to such influences speculation must at times be rampant. One man will buy shares not because he wants to invest his money for some appreciable time, but because he thinks that within a week or a month or a year the shares will go up in value and he will be able to make a big profit on resale. Again, we have seen that by the custom of the Stock Exchange bargains

have to be settled once a fortnight. A man may, therefore, at the beginning of the fortnight buy shares which he cannot pay for or sell shares which he has not got, and know that before the fortnight is up and the settling day reached he can effect a counter sale or purchase. Thus a man who buys shares at £1 and sells them before settling day for 25s. has made a profit of 5s. without having to put up a penny, and it is this man who is known as the "bull". The "bear", who sells shares which he has not got, may sell at the beginning of the fortnight at, say, 30s., and buy back again before settling day at 20s., and so make 10s. per share without ever having had a share in his possession. Of course, if the market goes wrong both bull and bear alike can get caught, and the cheapest escape they can have is to pay the difference between the buying and selling price.

The speculator has long been the subject of abuse, much of which is well merited. There are no words strong enough to condemn a man who propagates false rumours simply to shift the market to suit his own ends. On the other hand, the speculator on the Stock Exchange as elsewhere does perform a useful function, for it is the speculator who creates a free and active market for the benefit of the genuine investor who buys stock because he really needs it, or sells it because he wants his money. To those about to speculate only two words of advice are necessary. The first is, don't, and the second is, if you must, do it with your eyes open, count the cost to you if things go as wrong as they possibly can go, and make certain that you can afford it.

CHAPTER XXIII

Public finance—The government's three financial functions—Currency—
The temptations of inflation—Its evils—The government and the
central bank.

THERE remains one very important branch of finance to be considered, and that is public finance, namely, the financial methods and operations of the government and of local authorities. The financial functions of the government fall under three main headings—(1) currency functions, (2) debt functions, (3) revenue and expenditure functions. The first, though very important, can be dismissed briefly, for, as we have already seen, it is the custom of the government of the country to delegate its currency functions to the central bank. The reason for this is a very simple one. If the government reserves to itself the right to issue fresh currency, it will itself always be subject to the temptation to issue currency notes to bridge any gap that may occur between the year's revenue and the year's expenditure. When it is remembered that the imposition of taxation is an unpopular measure, while many kinds of expenditure of public money are popular, it will be realised that the temptation is a very pressing one, and experience has shown over and over again that governments have fallen to the temptation.

It need hardly be said that a government, no more than anybody else, can obtain something for nothing, and that all government expenditure has to be paid for by the country whether it is apparently covered by taxation or in other ways. In this particular case, when a government covers a

deficit in its yearly accounts by the issue of currency notes, it has by that very action allocated to itself so much additional purchasing power without adding anything to the volume of goods and services to be purchased. There is no difference between the government that issues currency to balance its budget and the gang of coiners who pursue their nefarious practices in an East-End cellar. In each case they are obtaining something for nothing and making the rest of the community foot the bill.

Currency inflation imposes upon the whole people the very real burden of higher prices, and it only remains to add that an increase in the cost of living can be just as serious a burden to the citizen as an extra 6d. in the £ income tax. More than that, the burden of currency inflation falls indiscriminately upon rich and poor alike. The burden of new taxes can be placed upon those shoulders best able to bear it.

To guard themselves against this temptation, most governments to-day delegate the power of currency issue to their central banks. This does not mean that they make the central bank independent of the government authority. The central bank in the last resort depends for its existence and its authority to act upon the law establishing it and upon its charter from the government, and the government which issues that charter can from time to time amend it. In practice the charter is amended at comparatively rare intervals, and so long as the central bank acts in the broad interests of the country it suffers no interference. But the supremacy of the government remains. In times of emergency the government may find it necessary to assume for itself the right of issuing currency; thus in 1914 the British Government passed legislation empowering it to issue currency notes direct from the Treasury. It is a question of opinion and of some controversy whether or not, even allowing for the grave emergency of the war, the government's right of note issue was not abused. It is, however,

a matter of history that less than ten years after the conclusion of the war the government surrendered its right, and transferred its currency notes to the Bank of England. At the same time, the Treasury very rightly maintains close touch with the Bank of England. Many Treasury operations, such as debt creation and redemption, and especially the management of the Floating Debt, are intimately connected with banking and currency questions, and so close, if informal, contact between the Treasury and the Bank is highly necessary.

CHAPTER XXIV

The National Debt—Its origin—Its justification—A popular fallacy—
The three forms of debt—The British National Debt—Government
stocks—Interest and sinking fund—Some examples of sinking fund
provisions—Redemption dates and prices.

THE next function of the government is that of the administration of the National Debt. The National Debt arises just in the same way as any other debt, namely, that from time to time the government, like any private individual, has spent more money than it has received. Usually, this state of affairs has arisen in time of war, for in war the safety of the nation and the maintenance of its forces in the field take precedence even over the rules of sound finance, just as a householder does not count the cost when he is engaged in extinguishing a fire in his house. There is also in war-time a feeling that the nation has enough dangers and hardships to bear without the burden of more than a certain increase in taxation. There is the knowledge that no burden of taxation, however heavy, can meet the whole cost of a modern war as and when such cost is incurred; furthermore, there is a specious theory that as posterity will benefit from the fruits of victory, so it is only right to ask posterity to take its share of the cost of the war. This argument of course is largely fallacious. If during the course of a war half the nation are taken away from productive work and set to digging trenches and fighting battles, while the other half are diverted to manufacturing guns, rifles and other war stores, while all the time both halves of the nation are consuming their daily quota of food, clothing and other goods

and services, it is idle to argue that the nation is not poorer at the end than at the beginning of the war, or that the war has not been paid for during the course of its progress. All that posterity can be made to do, even if it is willing, is to see to it that its production and earnings exceed its consumption and expenditure so that the savings frittered away during the war are bit by bit replaced—and even assuming that posterity is willing or can be forced to make such sacrifices, everybody knows that the first thing those who survive a war want to do is to have a good time. The remedy is to have no more wars. This, however, is a digression.

The National Debt of a country takes three main forms—funded debt, unfunded debt and floating debt, to which should be added debt due to foreign governments or to foreigners.

The following table shows the composition of the British National Debt on 31st March 1928:

	£ million.
1. Funded Debt—	
2½% Consols	276·2
2½% (1905) Annuities	2·4
2½% Annuities	21·1
3½% Conversion Loan	832·3
4% Consolidated Loan	204·3
Debts to Banks of England and Ireland	13·6
Total Funded Debt	1,349·9
2. Unfunded Debt—	
4½% War Loan	12·8
5% „	2,172·3
4% „	80·3
4% Funding Loan	385·4
4½% Conversion Loan	220·9
4% Victory Bonds	343·0
Exchequer Bonds	15·6
National War Bonds	193·8
Treasury Bonds	675·4
National Savings Certificates	362·4
Total Unfunded Debt	4,461·9

3. Floating Debt—	£ million.
Treasury Bills	526.9
Ways and Means Advances	161.8
	<hr/>
	688.7
4. American Debt and "other" debt	1,097.0
	<hr/>
Total of National Debt	7,597.5

For the sake of simplicity, several minor items, such as certain stocks tendered to the government in payment of death duties, are omitted. Their inclusion would reduce the figure given above to £7,527,800,000.

The distinction between funded, unfunded and floating debt is mainly one of the date of repayment. Funded debt is either irredeemable or only redeemable at the end of a long space of time. Unfunded debt is redeemable within a comparatively short time, while, as described on a later page, floating debt is money borrowed temporarily and repayable within the year.

Funded and unfunded debt can be conveniently considered together, for they both take the form of securities quoted on the London Stock Exchange. They are issued, like any other stock, carrying a fixed rate of interest and at a fixed price and with defined terms of repayment. Once they are issued, they are dealt in on the Stock Exchange at the current prices of the day, just like other stocks and shares. Their price, however, is governed mainly by the current level of interest rates, for the security behind British Government stocks is primarily that of the revenue of the British Government and in reality that of the nation as a whole—in other words, the security is unimpeachable. That is why British Government stocks are known as gilt-edged securities.

To show how the price of British Government stocks is governed by the rate of interest, if the buyer wants a level 5 per cent, he will only pay £50 for £100 of 2½ per cent

Consols, £70 for £100 of $3\frac{1}{2}$ per cent Conversion Loan, and so on.

The Treasury has three main duties in regard to the National Debt. These are: (a) to provide for interest; (b) to provide for repayment; and (c) to carry out conversions.

Interest and Repayment.—The budget of 1928 enacted that every year a sum of £355,000,000, forming part of the Consolidated Fund, should be allocated to these purposes. The year's interest on the National Debt is first paid out of this sum, and the rest forms the sinking fund of the country, this being the term usually given to money set aside for the repayment of debt. Now, many of the loans included in the list previously given have special sinking fund provisions, these being part of their original terms of issue. Thus, in the case of $3\frac{1}{2}$ per cent Conversion Loan, so long as the Stock Exchange price remains below 90, one per cent of the amount outstanding must be bought by the National Debt Commissioners at the current market price, and cancelled. The money required for the purchase is drawn from the sinking fund. In the case of 4 per cent Victory Bonds, it is provided that each half-year a sum of money originally fixed at $2\frac{1}{4}$ per cent on the whole shall be set aside for these interest and sinking fund requirements. The interest is met first and then a certain number of the bonds, equivalent at their par value to the money available for their repayment, are drawn by lot and paid off at par. As the bonds were originally issued at a price of £90 per £100 bond, and as their market price has consistently remained below par, holders of drawn bonds get a profit on repayment equal to the margin between par and the current price of the bonds.

Certain of the other government stocks have sinking fund provisions of a similar character, and all these special sinking funds form a net charge upon the annual sum of £355,000,000. This money also has to bear the cost of the excess, if any, of savings certificates encashments over issues. Any balance remaining is used by the National Debt

Commissioners for redeeming debt generally, as they think fit.

The sum of £355,000,000 may at times be inadequate to meet all the special requirements enumerated above. If so, the deficit must be met by further borrowing, probably by an addition to the floating debt. This is bad practice, as it is equivalent to borrowing "short" to repay long-term debt, and for this reason the Chancellor of the Exchequer was criticised for making too small provision. It is, however, clear that as time goes on and debt is gradually redeemed, less will be required for interest and more will be available for redemption.

In any case it must be remembered that unfunded debt consists of stocks which must be redeemed at the end of a particular time. Often the time of redemption consists of a period of several years. Thus, 5 per cent War Loan is redeemable at any time, at the government's option, between 1929 and 1947. This explains why its price remains around £100, even when its rate of interest was slightly higher than the yield generally acceptable upon gilt-edged stocks. The reason was, no one would pay more than £100 for a stock which could be paid off at any moment at par.

CHAPTER XXV

Debt conversion—What it means—Difficulties—Example of a conversion offer—Its lessons—Floating debt—Treasury bills—Ways and means advances—The war increase in the floating debt—Its consequences.

Conversion.—During the war the government had to borrow as best it could, and often issued stocks running only for a short time and carrying a high rate of interest. During the past ten years many of these stocks have reached maturity, and others have remained with interest rates higher than the general post-war level. Hence one of the main tasks of the Treasury has consisted of converting these stocks into longer-dated stocks at a lower rate of interest. A conversion operation usually takes this form. The government says to the holders of a maturing loan: "We are ready to pay you off in cash here and now, and to keep our bargain with you. But as you will probably want to re-invest the money, we will give you the choice of accepting new government stock in exchange. The new stock will not be the same as the old, for we are offering stock of a longer date and a lower rate of interest than your present stock. But if you don't like it you can have cash, and you know that if you re-invest your cash you cannot to-day get better terms than we are offering you." The fixing of the exact terms so as to get the new conversion loan taken up by the majority of the holders of the old loan, without making the interest on the conversion loan too high, is the whole art of the game. If interest rates are low, the game is easy, but if maturities have to be dealt with when interest rates are high, the Treasury's best chance is to offer a new short-term loan such as one of the Treasury

Bond issues. This tides over the government until markets become more propitious, and at the same time offers to bankers and others who have to keep their assets liquid a suitable gilt-edged security. Thus a demand for the new stock is assured.

Such loans as the various conversion loans came into existence mainly as the result of successful post-war conversion operations. In practice, the offer takes something like the following form: "Buyers of gilt-edged stocks are to-day content with a yield of $4\frac{1}{2}$ per cent. You hold a £100 5 per cent War Bond, which is due for repayment at £105—that is, you can claim £105 in cash for your bond. Now, if you invest £105, it will bring you in at $4\frac{1}{2}$ per cent £4:14:6 per annum. £135 of $3\frac{1}{2}$ per cent Conversion Loan will bring you in as much. So, instead of cash, you are offered £135 of Conversion Loan."

To strike a balance, the investor loses 5s. 6d. a year in interest if he accepts the offer, but then he would equally have lost it if he took the money. The government save 5s. 6d. in interest at the cost of an increase of £35 in the nominal size of the National Debt. Still, as Conversion Loan is not repayable for a long time, there is a popular belief that this does not much matter.

The value of this example is that it shows first of all how a successful conversion operation saves interest, and secondly, why it is that conversion operations often increase the size of the National Debt, even though they save the government money.

The Floating Debt.—This originally was money raised for short periods, for months or even weeks, designed to meet the gap which occurs every year between revenue and expenditure. It is comparable to the position of a man who has household bills to meet every week but only gets his salary in one lump sum at the end of the year, for, as we shall see later, the Government is spending money every day, while the bulk of taxation only comes in at certain definite periods

of the year. It consequently finds itself running into debt at one season of the year and repaying it at the end.

The floating debt of Great Britain takes three main forms.

(1) *Treasury Bills*.—These are bills of exchange, mostly three months' bills, drawn on H.M. Treasury and payable by the Treasury on maturity. Each week the Bank of England, on behalf of the government, announces that it has so many Treasury bills on offer, and those applicants who offer the best prices for the bills get them. The price offered, as in the case of every other bill of exchange, is expressed in terms of so much per cent discount: thus, if the week's Treasury bills are sold at a price of 99 per cent for the three months' bills, then the rate of interest on three months' Treasury bills for that week is clearly 4 per cent. The rate of discount on Treasury bills, just like the discount rate on other first-class bills, clearly cannot rise above bank rate, as otherwise people would take up Treasury bills at a higher rate and promptly turn them into the Bank for discount at the lower.

Treasury bills once issued are, of course, bought and sold in the Money Market like other bills of exchange, so that in addition to the rate of discount announced each Friday on the week's issue of new Treasury bills, there are also rates of discount quoted in the market for outstanding Treasury bills of various maturities. From the government's standpoint—which is what we are now chiefly concerned with—the Treasury bill represents a definite way of tapping the supplies of floating money always present in the London Money Market.

(2) *Advances from Public Departments*.—Various government departments occasionally find themselves in possession of large supplies of cash which have been allocated to them by the Treasury, and which at the moment do not happen to have been spent on the purpose for which they were allocated. Thus, the road fund receives each year the bulk of the money collected by the government in payment for licences

on motor vehicles. That money is spent partly on the maintenance of existing roads and partly on the construction and development of new roads, and some of it may not be used at once, or even for several years; similar examples occur in other public departments. The Treasury, consequently, is in the habit of borrowing some of this money, and classes such borrowings as advances from public departments under the broad heading of the Floating Debt.

(3) *Advances from the Bank of England.*—The Bank of England is by right the government's bank, and the government occasionally overdraws just like any ordinary individual. This overdraft is known as Ways and Means Advances. The government, of course, pays interest on such advances at rates agreed upon between it and the bank.

It has been said that the original function of the floating debt was to meet temporary differences between revenue and expenditure. Unfortunately, during the Great War it was found necessary to increase the floating debt enormously, not to meet these temporary fluctuations but to help pay for the Great War. The result was that we came out of the war with a hugely increased floating debt. For a time this had two very bad effects. First of all the Money Market found itself swamped with Treasury bills, and secondly the government during the war found that Ways and Means Advances provided a ready method of inflating the currency of the country without being detected in the act. The reason for this is very simple. The Bank of England is fundamentally like every other bank, and a government loan from the Bank of England means a corresponding increase in the Bank of England's deposits in exactly the same way as a loan to a private citizen from his own joint-stock bank. As the Bank of England's deposits are an integral layer in the credit structure of the country, it is clear that an increase in the Ways and Means Advances from the bank to the government means a general increase in the supply of money in the country.

CHAPTER XXVI

Government expenditure—Public services—Social services—The government and trade—The government as trader—The psychological effect of taxation—Expenditure on debt service—Parliament and expenditure—The estimates—The Consolidated Fund—The budget.

THE third financial function of the government is also the chief one, *i.e.* the management of the revenue and expenditure of the nation. Consider for a moment why it is that the government has to collect money and to spend it. When anybody spends money on goods and services, he is exercising his power of getting somebody else to do something for him or of providing him with some of his needs; just as when he receives money in exchange for providing goods and services himself, he is doing or making something for somebody else. Now, there are certain services which we can best perform for ourselves, many others which we find it better to get others to do for us while we specialise ourselves on our particular line of work, and finally, there are certain services which have to be performed which do not benefit any one person in particular but are beneficial to the community as a whole. To illustrate this contrast, we each of us need our own particular butcher, baker and doctor; we do not each of us need our own particular policeman.

This, therefore, is the first function of the government, to perform those services which are necessary to the community as a whole rather than to any particular person. Maintenance of law and order, the protection of the country from outside aggression, whether such protection take the form

of armed forces or the maintenance of international law and order through the League of Nations; promotion of public health; the organisation of government offices: these are some of the services rendered to the community as a whole.

The next group of services are of a slightly different character. They arise from the fact that every civilised community feels a certain sense of duty to its less fortunate members. Thus in England, at least, the community renders such services as the provision of Old Age Pensions; the maintenance and subsidisation of insurance schemes against sickness and unemployment for the poorer members of the community; the provision of free education; the provision of a minimum means of subsistence for everybody, however poor; and in general all the group of government activities popularly known as social services. To a certain extent these represent a rough and ready attempt to equalise the differences between rich and poor. It is possible to regard £1000 paid by a rich man in income tax and distributed in the form of Old Age Pensions as an instance of equalising conditions. It is equally possible to say that a man who has given his best to the community during his years of activity has fairly and squarely earned his pension, and his more fortunate fellow should be only too grateful that he has the means to contribute towards it. In any case, judged on the lowest grounds, there can be no question that it is better for a country to have a contented, comfortable, happy and well-educated population than to abandon large sections of the community to drift into disease, poverty and crime. It is better business to spend money on schools than on prisons.

Next comes the assistance rendered by the government to those engaged in trade and industry. How far that assistance should go is clearly a matter of controversy. It would, for example, be unfair of the government to collect money from the community as a whole simply to assist one particular part. For example, it is not likely that another government will for years to come repeat the experiment of the coal

subsidy of 1925-26.* On the other hand, it is clearly desirable that the government should maintain its own officers, such as consuls in foreign countries, to assist home traders who may get into difficulties, and also to furnish the trading class as a whole with information regarding foreign markets. It is desirable that the government should furnish the British community with information on vital matters which the government alone is able to collect; for example, the monthly returns of imports and exports. It is desirable that the government should protect honest traders and manufacturers who have regard to the comfort and safety of their work-people against less scrupulous competitors, and hence we have such government duties as the enforcing of the Factory Acts, Safety Regulations in Factories, and in the financial sphere, enforcing all the legislation affecting limited companies. It is also desirable that where the whole trade of the country is threatened by some labour dispute the government should be able to intervene and, if desired, to arbitrate between the parties to the dispute.

How far the government should engage in actual trade is another matter, and one which would best be deferred until we have seen exactly how trade and industry function. There are, however, certain services, both productive and distributive, which the whole community require and which by common consent are best handled by the government or by the local authority, the distinction being purely one of convenience. The provision of ample supplies of pure water, maintenance of roads, the drainage of streets and houses, and finally the post office and telephone service, are obvious examples of this: and some, at least, of these activities are conducted, not at the expense of the community, but in such a way as to yield profit to the community. In general, however, there is one point that might fairly be met here and now. It is that as a rule every activity of the government

* This sentence was written before the introduction of the 1929 Coal Bill.

costs money which the community as a whole has to find. Now, human nature being what it is, a man would far rather spend his own money himself than hand it over to the government to spend for him. Most people are likely to work a little harder and earn a little more, and at the same time render a little more service to their fellows, if they know they are going to reap their own reward, and are not going to have to part with it to the government, who to them is represented by the tax collector. It follows that every fresh activity of the government involving the imposition of additional taxation starts with the balance of national advantage against disadvantage slightly loaded against it, simply because the collection of fresh taxation in itself damps down a little the total of national activity.

The fourth object of government expenditure can be dealt with very briefly, though to-day it is a very serious item, *i.e.* the service of the National Debt—the payment of interest on outstanding debt, and also the provision of the required sinking funds. The community to-day gets no return from money so spent. The only comfort it has is that it may or may not have had in the past an adequate return for the expenditure which called forth the creation from time to time of fresh national debt.

By the traditions and practices of the British constitution, control of all government expenditure is vested in Parliament, and every spring during February and March the House of Commons is engaged in "voting supply", this being the term given to the authorisation by Parliament of the expenditure for the new financial year, which begins every April. Each government department has in turn to present to the House of Commons its estimates for the coming year, and Parliament is at perfect liberty to reject or amend these estimates if it thinks fit. There are, however, certain items which are borne by what is known as the Consolidated Fund of the United Kingdom, and for these Parliament does not have to vote supply in detail. Consolidated

Fund items represent on the whole such expenditure as the government is morally bound to make, and which it is inadvisable should be made the subject of political controversy each year. The service of the National Debt, Judges' Salaries, and our contribution to the Government of Northern Ireland are examples of this.

Once Parliament has voted supply, and the results of the preceding financial year are known, the Chancellor takes stock of the position. He knows on the one hand what estimated expenditure he is committed to for the new financial year, and he knows how much revenue he got in the last year, and how much existing taxes and other sources are likely to give him in the new year. It is on such calculations that he bases the year's budget, which he lays before Parliament towards the end of April.

The Budget is a statement outlining the financial position of the government, giving the probable revenue and expenditure for the new financial year, and saying what changes in taxation and other financial measures the government proposes to ask Parliament to authorise. If Parliament approves, it first passes "the budget resolutions" giving the government temporary authority. It then has to pass the Finance Bill, which is a bill embodying in detail and in legal form all the changes outlined in the budget. Only the House of Commons is concerned with financial measures. Since the passage of the Parliament Act in 1911, the House of Lords has had no financial powers.

CHAPTER XXVII

Revenue and direct taxation—Income tax—Reliefs and their principle
—Income tax on company profits—Super-tax—Estate duties—An objection and its answer—A general objection to direct taxation.

HAVING dealt with government expenditure we come now to the collection of revenue by the government. Revenue falls within three main divisions—(1) tax revenue, (2) non-tax revenue and (3) self-balancing revenue.

Taxation is the way in which a government makes its nationals contribute, according to their ability, to the cost of the service the government performs for the nation. Tax revenue is divided into two divisions, namely, direct taxation and indirect taxation. The distinction between the two is broadly that direct taxation is levied upon people and indirect taxation upon goods and services. The three chief direct taxations are Income Tax, Super-tax and Estate Duties. Income tax is levied directly upon the incomes of individuals and also the annual profits of companies. The standard rate of tax is fixed at present at 4s. 6d. in the £, *i.e.* at this rate a man has to pay in tax 22·5 per cent of his income. This standard rate, however, does not take effect upon the first £250 of taxable portion of the tax-payer's annual income, which is only charged at 2s. in the £. Besides this, a tax-payer is allowed certain reliefs. For example, on such portion of his income that is derived from his own labour and not from his invested capital, he is only taxed on $\frac{5}{6}$ ths of the total amount. Again, all tax-payers are allowed to retain a certain portion of their income free of tax altogether,

e.g. a bachelor is not taxed at all on the first £135, while a married man receives an allowance of £225 plus an additional allowance for children. Other allowances are also provided for, and the general object of the British Income Tax scale is to give a certain amount of relief to those with small incomes and with family responsibilities, while at the same time to get the full amount of tax out of the more prosperous payers. The principle is this. The first £250 or so of a married man's income he must have unencumbered, as he needs it in order to keep himself and his dependents in bodily comfort. Any further income is not a vital necessity to him but is spent, partly at least, on luxuries and therefore can be subjected to income tax.

A company pays income tax on its profits whether such profits are distributed to the shareholders in dividends or are placed to reserve and retained in the business. The company in its turn is bound to deduct income tax at the standard rate from the total amount of dividend paid to the shareholders, and the shareholders would then make their own income tax return to the authorities, showing separately those dividends from which income tax had already been deducted. It sometimes happens that a company declares a dividend of, say, 4 per cent free of tax. This statement is most misleading, because all dividends, like other forms of income, are liable to income tax. What it really means is that a company has declared a dividend of 5 per cent and has paid 1 per cent direct to the tax collector, and distributes the other 4 per cent to the shareholder.* With income tax at 4s. in the £ a dividend of 5 per cent less tax is clearly identical with a dividend of 4 per cent free of tax.

Just as the income tax laws provide some measure of relief to the small incomes, so it is thought equitable that the large incomes should pay a further tax in addition to the standard rate of 4s. in the £. Super-tax is levied upon incomes over £2000, and its rate rises with each increase in

* Income tax is here taken as being 4s. in the £.

the total income, so that on very large incomes income tax and super-tax together may amount to as much as half a man's income. Super-tax, or surtax, as it is now called, is simply the continuance of the principle that the bigger a man's income is the more he can afford to pay in taxation. A tax of 10s. in the £ on an income of £20,000 imposes a far less burden than it would upon an income of £200, simply because a man can see his income cut from £20,000 to £10,000 without suffering privation, while if it were cut from £200 to £100 he would find himself deprived of comforts which he really needed.

When a man dies and his estate passes to his heirs, the government levy a tax upon his estate, the rate of taxation depending partly on the size of the estate and partly upon how closely his heirs are related to him. Here again the principle is that the bigger the estate the more can the heirs be equitably asked to surrender in taxation, while it is only natural that when a man bequeaths his property to his children they should escape with a lower rate of taxation than if he bequeathed it to a distant connection. Estate duties are attacked from time to time on the ground that while they are a tax upon the nation's capital the proceeds of the tax are devoted to current expenditure. There is some justification in this attack, for if it is unwise for a private individual to fritter away his capital upon his daily needs, it is still more wrong for the community as a whole to fritter away part of the capital left by one of its members. Estate duties, however, are a convenient form of taxation for they deprive the testator of part of his property at the moment when he has ceased to need it, while the heirs are only deprived of a portion of what they are about to receive. In any case, the government has a partial answer to these attacks, for it can point out that the revenue derived each year from estate duties is partly balanced by the amount it sets aside each year to the sinking fund for the repayment of the National Debt; in other words, it is not wholly fritter-

ing away the nation's capital by current expenditure, but is using it to get the nation out of debt, so that one capital transaction is balanced by another. Of course, in so far as the yield from estate duties exceeds the provision for debt redemption, the answer ceases to be valid. There is thus a strong argument in favour of redeeming debt each year by an amount at least equal to the yield of estate duties.

There is one further argument against all direct taxation. It is that while income and profits are more often earned not in cash but in other forms, and while a man's estate consists not so much of cash as stocks and shares, land, houses and furniture, all these taxes are payable in cash. This means that in order to pay income and super-tax, traders may find themselves denuded of the cash they need as working capital, while executors are often faced with the need of selling up a portion of the estate they are handling in order to find the money for the estate duties; furthermore, income tax is only payable after several months have elapsed from the period during which the income is earned, and unless the tax-payer has exercised foresight he may have already spent his income before he has to find the money for the tax. Thus, a person may earn a profit one year and incur a loss the next. At the moment when he is incurring his loss he may find himself having to pay his tax on the profits of the preceding year. The wise man, of course, as, and when, he earns his profit, sets aside the money he needs for income tax, and in preparation for his death he will also insure his life for a sum in cash equivalent to what is needed for the duties on his estate. But all men are not wise, and it is for this reason that complaints are often heard that direct taxation cripples trade, raises prices, is a hindrance to production and leads to forced sales of property at less than its real value.

CHAPTER XXVIII

Indirect taxes—Customs and excise—Stamp duties—Non-tax revenue—
Self-balancing revenue—The weekly revenue return—Its significance.

THE most important indirect taxes are customs and excise duties. The customs duty is a tax paid by those who bring certain articles into the country from abroad. Thus, on every cwt. of coffee imported a duty of 14s. is payable, and on every gallon of petrol a duty of 4d. Excise duties are exactly similar except that they are levied on goods produced at home, such as beer and spirits. As a rule, customs and excise duties are levied upon luxury articles as opposed to necessities, though there is at least one important exception, namely, sugar. In most cases, too, in England, customs duties on foreign goods are balanced by excise duties on home goods, although in recent years the excise duty has been modified, as has the customs duty on articles coming from other parts of the British Empire. In certain cases, too, no excise duty at all is imposed. For example, there is a customs duty on motor-cars, but no excise duty. In this case the customs duty is known as a protective duty, for it is deliberately designed not only to raise the revenue but also to tax foreign goods and raise their price, and so help the home manufacturer. For further consideration of this very controversial matter the reader is referred to a subsequent chapter.

Another important tax, which is not invariably described as an indirect tax, consists of stamp duties. A large number of transactions and agreements between people have to be

supported by documents. A bill of exchange is a clear case, for it is a written order to somebody to pay money in respect of some particular transaction. The contract between two parties for the execution of some transaction is another, and many such examples can be thought of. The government has long found that a convenient way of raising money is to enact that all these documents should bear a stamp which must be purchased from the government. These stamps are of varying values depending on the nature of the document and the monetary value of the property at issue. The revenue from the sale of these stamps is known as Stamp Duties. It is an easy way for the government to raise money, for it has only to say that the documents are not legally binding upon the persons signing them unless they are properly stamped. Whether or not it is a proper way to raise money is another matter. For one thing, there are obvious objections to levying taxation upon the conduct of business.

The above are the main taxes in force in England to-day. Non-tax revenue is easily explained. The profits of the Post Office are one example; rent from land owned by the Crown is another; interest on war debts due to England by foreign powers is another, as are also dividends on stocks owned by the British Government, such as the Suez Canal shares. Immediately after the war a big source of non-tax revenue was the proceeds from the sale of surplus war stores. These proceeds rightly represented the realisation of capital, and the government was not justified in sweeping them into the revenue of the year in which the proceeds were received, as in point of fact it did. The same criticism applies to the inclusion in the year's accounts of such portions of foreign debt payment as represent principal and not interest.

Finally comes self-balancing revenue. This includes first of all such receipts at the Post Office as are balanced by the cost of running it. Secondly, such receipts and taxes upon motor vehicles as are balanced by government expenditure upon roads. It may be added here that motor vehicle duties

yield more than the government is bound to spend upon roads and the difference is included in the tax revenue.

On the following pages will be found a statement of revenue and expenditure returns of the government published every week. There are two main points which merit brief consideration. The first is that all items in the account represent the actual receipt or expenditure of cash, which falls due but has not been included in the account. The next is that the account includes all cash payments and receipts in respect of National Debt. Thus, on one side will be found a statement of the Treasury bills issued during the week, and on the other side, of Treasury bills redeemed during the week. Here again it is necessary to emphasise that all items represent cash. The account is not a balance-sheet nor a profit and loss account in the usual commercial sense.

PUBLIC INCOME AND EXPENDITURE

RECEIPTS INTO AND ISSUES OUT OF THE EXCHEQUER

REVENUE AND OTHER RECEIPTS	Estimate for the Year 1929-30.	Total Receipts into the Exchequer from		Week Ended Sept. 7, 1929.	Week Ended Sept. 8, 1928.
		April 1, 1929, to Sept. 7, 1929.	April 1, 1928, to Sept. 8, 1928.		
ORDINARY REVENUE					
Inland Revenue—	£	£	£	£	£
Income Tax . . .	239,500,000	52,972,000	49,814,000	2,967,000	1,191,000
Super-Tax . . .	58,000,000	10,900,000	10,500,000	180,000	130,000
Estate, etc., Duties	81,000,000	38,080,000	33,790,000	1,060,000	950,000
Stamps . . .	31,000,000	9,570,000	11,400,000	210,000	1,570,000
Excess Profits Duties, and Corpora- tion Profits Tax	1,700,000	10,000	360,000	..	..
Land Tax and Mineral Rights Duty, etc. . .	800,000	160,000	150,000	..	..
Total Inland Revenue	412,000,000	111,692,000	106,014,000	4,417,000	3,841,000
Customs and Excise—					
Customs . . .	119,850,000	53,629,000	50,897,000	2,967,000	3,704,000
Excise . . .	130,550,000	52,163,000	54,388,000	763,000	925,000
Total Customs and Excise . . .	250,400,000	105,792,000	105,285,000	3,730,000	4,629,000
Motor Vehicle Duties (Exchequer Share)	4,700,000	1,772,000	1,522,159	178,000	132,000
Post Office (Net Re- ceipt) . . .	8,900,000	6,350,000	4,600,000	900,000	200,000
Crown Lands . . .	1,250,000	560,000	510,000	..	..
Receipts from Sundry Loans . . .	30,550,000	10,250,423	8,376,430	78,688	107,133
Miscellaneous—					
Ordinary Receipts	12,500,000	2,792,079	4,025,511	6,048	43,756
Special Receipts .	26,000,000	11,393,315	9,039,852	2,750,000	24,633
Total Ordinary Re- venue . . .	746,300,000	250,601,817	239,372,952	12,059,736	8,977,522
SELF-BALANCING REVENUE					
Post Office . . .	58,110,000	23,950,000	23,900,000	900,000	900,000
Motor Vehicle Duties apportioned to Road Fund . . .	22,600,000	5,969,000	5,718,841	..	..
Total Self-Balancing Revenue . . .	80,710,000	29,919,000	29,618,841	900,000	900,000
Total . . .		280,520,817	268,991,793	..	..

PUBLIC INCOME AND EXPENDITURE—*continued*

REVENUE AND OTHER RECEIPTS	Total Receipts into the Exchequer from		Week Ended Sept. 7, 1929.	Week Ended Sept. 8, 1928.
	April 1, 1929, to Sept. 7, 1929.	April 1, 1928, to Sept. 8, 1928.		
OTHER RECEIPTS				
Temporary Advances Repaid— Under the Unemployment Insurance Acts, 1920 to 1928 . . .	£ 1,660,000	£ 714,432	£ 20,000	£ ..
Money Raised by Creation of Debt—				
(a) For Capital Expenditure Issues:				
Under the Telegraph (Money) Act, 1925, and Post Office and Telegraph (Money) Act, 1928	2,300,000	2,550,000	..	..
(b) Under the Unemployment Insurance Acts, 1920 to 1928	1,350,000	3,010,000	..	110,000
(c) For other Issues:				
By Treasury Bills	1,388,983,000	1,076,527,000	66,500,000	51,187,000
By National Savings Certificates	17,350,000	16,800,000	700,000	600,000
By National War Bonds By 5 per cent Treasury Bonds, 1933-35 . . . . .	..	93,550,113	..	3,115,000
By 4½ per cent Treasury Bonds, 1932-34	26,300,972	..	..	..
(d) Ways and Means Advances Repayments—	280,710,000	244,700,000	10,710,000	14,300,000
In respect of Issues under Land Settlement (Facilities) Acts, 1919 and 1921	85,202	85,531	32,102	32,258
Balances in Exchequer on 1st April—	1929. £	1928. £		
Bank of England	5,515,917	5,918,513		
Bank of Ireland	736,607	404,112		
Total	2,005,512,515	1,713,251,504	90,921,838	79,221,780

PUBLIC INCOME AND EXPENDITURE—*continued*

EXPENDITURE AND OTHER ISSUES	Estimate for the Year 1929-30 (including Supple- mentary Grants).	Total Issues out of the Exchequer to meet Payments from		ISSUES	
		Apr. 1, 1929, to Sept. 7, 1929.	Apr. 1, 1928, to Sept. 8, 1928.	Week Ended Sept. 7, 1929.	Week Ended Sept. 8, 1928.
ORDINARY EXPENDITURE					
Interest and Manage- ment of National Debt	£ 304,600,000	£ 152,475,705	£ 151,566,458	£ 5,559,207	£ 1,474,014
Payments to Local Tax- ation Accounts* . .	15,000,000	2,748,620	3,187,993	121,317	..
Payments to Northern Ireland Exchequer . .	5,400,000	1,994,331	1,668,655	178,571	163,429
Other Consolidated Fund Services . . .	3,500,000	1,626,028	790,525	..	11
Supply Services (ex- cluding Post Office) .	363,318,000	147,852,428	143,095,303	6,609,000	7,904,000
Total Ordinary Expenditure . . .	691,818,000	306,697,112	300,308,934	12,468,095	9,541,454
Sinking Fund . . .	50,400,000	19,441,690	24,947,585	1,894,267	625,000
SELF-BALANCING EXPENDITURE					
Post Office	58,110,000	23,950,000	23,900,000	900,000	900,000
Road Fund	22,600,000	5,969,000	5,718,841	..	..
Total Self-Balancing Expenditure . . .	80,710,000	29,919,000	29,618,841	900,000	900,000
Total		356,057,802	354,875,360	15,262,362	11,066,454

* Transferred to Supply Services, 1930-31.

PUBLIC INCOME AND EXPENDITURE—*continued*

EXPENDITURE AND OTHER ISSUES	Total Issues out of the Exchequer to meet Payments from		ISSUES	
	April 1, 1929, to Sept. 7, 1929.	April 1, 1928, to Sept. 8, 1928.	Week Ended Sept. 7, 1929.	Week Ended Sept. 8, 1928.
OTHER ISSUES				
Temporary Advances—	£	£	£	£
Interest on Exchequer Bonds under the Capital Expendi- ture (Money) Act, 1904 . . .	18,458	18,458	..	..
Under the Unemployment In- surance Acts, 1920 to 1928 . .	1,350,000	3,010,000	..	110,000
Issues to meet Capital Expendi- ture—				
Under the Telegraph (Money) Act, 1925, and the Post Office and Telegraph (Money) Act, 1928	4,050,000	4,200,000	..	..
Unemployment Insurance Acts, 1920-28, Repayment of Amounts Borrowed	1,660,000	714,432	20,000	..
Redemption of Debt—				
Treasury Bills	1,317,985,000	984,975,000	66,400,000	47,135,000
Principal of National Savings Certificates	18,800,000	18,500,000	750,000	700,000
Principal of National War Bonds paid off . . . . .	..	77,915,810	..	15,500,000
Principal of Treasury Bonds paid off	29,409,505	..	..	..
Other Debt under the War Loan Acts, 1914 to 1919 . .	414,012	3,341,000	..	..
Securities surrendered for Duties under Section 34 of the Finance Act, 1917	24,783	..	2,470	..
Ways and Means Advances Repaid	270,910,000	263,350,000	9,010,000	5,200,000
Depreciation Fund under the Finance Act, 1917	2,460,637	..	..	..
Old Sinking Fund, 1907-08— Issued under Section 9 of the Finance Act, 1908 . . . .	..	1,000	..	..
	2,003,140,197	1,710,901,060	91,444,832	79,711,454
Balances in Ex- chequer—	Sept. 7, 1929. £	Sept. 8, 1928. £		
Bank of England	2,020,725	2,080,222	..	..
Bank of Ireland	351,593	270,222	2,372,318	2,350,444
			- 89,995	- 73,674
			- 432,999	- 416,000
Total	2,005,512,515	1,713,251,504	- 522,994	- 489,674

CHAPTER XXIX

Local government finance—Municipal services—The supremacy of the national government—The need for co-ordination—Municipal trading—Rates—Their weakness—De-rating—The changes of 1928 and 1929.

IN addition to the services paid for by taxation and performed by the national government there are all the activities of local authorities, including County Councils, Urban and Rural District Councils, Borough Councils and Parish Councils. The services these bodies perform are naturally of a local character. They include the maintenance of roads and footpaths, street lighting, drainage and dust collection, the supply of water and occasionally of gas and electric light, the police force and fire brigades, and finally the administration of public health measures, the provision of adequate education facilities for children whose parents cannot afford or prefer not to use private schools, and the care of the poor. All these are services which are essentially of a local character. The Manchester fire brigade or police force mainly protects the people of Manchester from fire and thieves, and so obviously ought to be administered by the Manchester City Council and not by the national government in London; and the same applies to many of the other services.

Local authorities, however, are not given an entirely free hand. For one thing, the right of absolute government is vested solely in the King, acting through Parliament, and local councils only exercise their powers under authority delegated to them by Acts of Parliament. Again, England is

not socially or economically divided into water-tight compartments corresponding to the areas controlled by each District or County Council, and it is desirable that there should be some correspondence in policy between the various local authorities, and indeed, some common standard of administration and performance as regards such services as poor relief and education. In some respects, too, the services provided by a local authority are not enjoyed solely by its own ratepayers. Roads, which may be used by people coming from all parts of the kingdom, are an obvious example. Finally, even services of an essentially local character are divided between the County Councils and the District Councils. Elementary schools, for example, come under the District and even under the Parish Council, while Secondary Schools are controlled by the County Council. In these days of motors, the cost of maintaining roads is shared between the District Council, the County Council and the Government itself, the size of each share rightly depending on whether the road is a main road serving the whole country, or a by-road serving only the immediate neighbourhood.

Sufficient has been said to show the general nature of local administration, especially as this book is more concerned with the financial side. A local authority raises its money from three main sources—(1) by levying “rates” upon its own inhabitants; (2) from government grants; and (3) from profits, if any, on such municipal undertakings as the corporation tramways, gas-works and electricity works. Birmingham even operates a municipal bank.

To discuss (3) first. Municipal undertakings earn or should earn profits in just the same way as other trading concerns. How far a municipality should enter into “trade” is a very controversial question. The main arguments in favour are that to obtain the greatest efficiency, such public utility services as transport, gas and electricity should be under a single control; in other words, they should form a monopoly, and a monopoly which must have certain legal powers over

travellers and consumers. For this monopoly to be in the hands of a private company creates a certain sense of injustice in the minds of the public, whereas if it was exercised by the local council, the public would know that they had their remedy at the next local elections. In fact, realisation of the dangers of a public utility monopoly is found in the fact that legal limitations on fares, prices and other conditions of working are very often imposed.

The great objection to municipal trading is that the council is liable to be swayed by "vote-catching" as opposed to business considerations. An undertaking's first duty is to earn its own keep, and a council responsible to electors is rather more prone to forget this than directors responsible to shareholders. Ratepayers ought not to be asked to pay other people's tram fares, or gas and electric light bills, which is what happens if the corporation operates at a loss.

Rates are the main form of taxation imposed by local authorities. A "rate" is a tax imposed upon all occupied dwelling-houses, shops, factories, business premises, etc., and also upon undertakings such as mines and railways. The amount payable in respect of each house, etc., is in direct proportion to its "rateable value", which in turn is determined by the local authority's assessment committee, and is supposed to represent the fair rent payable for the house, less an allowance for repairs. Rates are usually expressed as "so many shillings in the pound". Thus if the rate is 10s. in the £, a house rated at £60 a year would pay £30 a year in rates.

When a local authority prepares its budget for the new financial year, it first estimates the sum it needs from the rates. Say this is £500,000. It next looks up the total rateable value of the property within its boundaries. Say this is £1,000,000. Simple arithmetic then tells it that it must levy a rate of 10s. in the £.

Rates are one of the oldest taxes in existence, and at the

time when they were first levied, the size of a man's house was a rough measure, and one easily applied, of his ability to pay. This is the origin of the form of local taxation, and until a few decades ago rates were on the whole an equitable kind of tax. Latterly, however, they have developed a tendency towards unfairness. The reasons for this are explained below.

(1) A farmer is (or was) rated on his land, a manufacturer on his factory, a shopkeeper on his shop. In these cases, rates are a tax not on his profits but on his raw material or tools or equipment. Whereas income tax is only payable on profits, and customs duties upon consumption, rates are payable even when business has fallen away and profits have become losses.

(2) Rates are partly spent on social services, such as poor relief and education. The poorer a town is, the more money will be required for these purposes, but it is just in the poorer towns that a rate of a given size will yield least. This explains the existence to-day of a rate of 5s. in a rich suburb, and one of 25s. in the £ in a depressed industrial area.

(3) Poor relief is spent partly on giving assistance to the unemployed and their dependents. Now, when an industry is working at a loss, works in it begin to close down and unemployment increases. This means an extra burden upon the rates, just when manufacturers in the district are already overlaid with misfortunes, and find production costs (of which their rates are a part) already too high.

(4) Many of the duties undertaken by local authorities were originally thrust upon them by the government, and take no account of the ability of any local authority to bear the cost of those duties.

(5) Land withheld from use is not subject to rates, even though its owner may be deliberately keeping it empty in order to get a higher price for it.

Much of the legislation affecting local authorities, culminating in the de-rating scheme of 1928, is designed to

mitigate these anomalies. The fourth has been met for many years by the system of government grants, which were cited above as the authority's second source of income. These grants were originally proportional to the cost of the services the local authority had been required to undertake. This was the "percentage grant system", which disappeared in the reforms of 1928-29.

Farmers, too, have gradually been relieved of their rates, for the first of the reasons given above, and now pay nothing on their land. Manufacturers, collieries and railways, since the autumn of 1929, have only had to pay one-quarter of the full rate, and it is this relief of three-quarters that is known as de-rating. This meets the case as regards reason (1), and to some extent as regards reasons (2) and (3). The only complete solution to the third reason is to make relief to the unemployed a charge on the tax-payer, and so spread a burden, now concentrated in the depressed areas, over the whole nation.

Merchants and shopkeepers still have to pay a full rate, even though their offices and shops are as much their equipment as is the plant and factory of a manufacturer. No attempt either has yet been made in this country to deal with the problem of unoccupied land.

The de-rating of factories clearly deprived local authorities of a portion of their revenue, and this the government had to make good out of the national revenue. Opportunity was taken to make big alterations in the apportionment of services between various authorities (*e.g.* the disappearance of the Poor Law Guardians and the transfer of their duties to the County Councils), while the "percentage" and other government grants were all merged into a new government grant designed to cover both the old grants and also the deficit arising from de-rating. The share of this grant received by each local authority is decided according to complicated rules, designed firstly to provide for each authority according to its needs, and secondly to mitigate any hard-

ship that might arise from the change-over from the old grants to the new. In conclusion, it is only fair to say that de-rating was in 1928 and 1929 a subject of keen political controversy, and that the new scheme has yet to stand the test of time.

CHAPTER XXX

Trade and exchange—Some general rules—An example—Founding the business—The initial balance-sheet—Some problems of business—The cost of production—Diminishing returns—Mass production—Output and costs.

THIS chapter begins the last portion of the book, which deals with the problems and methods of modern trade and industry, defining these terms in their widest sense, so as to embrace capital and labour, agriculture and manufacture, production, distribution and consumption. It really contains the answers to the lessons propounded in the opening of the book.

The whole principle of life is to make for other people what they want and then exchange it for what you want yourself on the best terms that you can honourably get. That is what every one of us is trying to do, and a happy and comfortable life is the reward of success. We have already seen how many of the lubricators of life work, such as the banker, the broker and the civil servant. They are all providing their fellows with help they need, and they are doing it in such a way as to earn their own living. We have now to see how the producer and the distributor play their part.

To begin with one or two simple statements, designed mainly to clear the ground:

(1) The term "producer" includes everyone engaged in production from the chairman of the directors down to the new apprentice. The division between capital, management and labour is of a totally different character.

(2) A manufacturer is not concerned solely with the process of manufacture. He must concern himself with at least four questions. These are (a) buying; (b) making; (c) selling; (d) finance.

(3) No manufacturer has the right to insist that others shall buy his product at his price. And no worker can claim that work must be forthcoming for him in his particular job.

The easiest way to understand how all these problems are solved is to consider a fictitious manufacturing company making, say, furniture through its various stages of birth and life. First of all the company has to be born and start work. Before it can make a single chair, some preliminaries are necessary.

(1) It will have to get a factory, equipped with all the machinery needed for making furniture. Say this costs £100,000.

(2) It will have to recruit its staff.

(3) It will have to lay in supplies of wood, glue, varnish and all the other materials needed. Say it buys £10,000 worth.

(4) It will have to pay people to organise all this, and also to attend to its own birth, *i.e.* issue the shares in the new company, pay the stamp duty on formation, etc., etc. Say this costs £5000.

(5) It must have some money in hand, as it will have to pay wages, etc., before it has sold its first chair. Say £10,000.

In other words, before it can supply the rest of the world with a single chair, it will have to have persuaded the rest of the world to build and equip for it a factory, to supply it with raw material, and also to do the work needed to bring it into existence.

It is for this reason that industry must have Capital, and there must be the machinery described in Chapter XX. to enable it to draw on people's savings for its capital. And finally, had not people saved in the past—that is, forgone demands

on their fellows, to which they were rightly entitled—the furniture company could not have made the demands upon its fellows to which it was not entitled, but which it had to make if it was to be born.

We will now take the initial balance-sheet of the company. This is fundamentally a statement of what property the company has acquired (its assets), and to whom it really belongs (its liabilities).

BALANCE-SHEET, 1ST APRIL 1929

<i>Liabilities</i>		<i>Assets</i>	
60,000	£1 6% Preference Shares . . .	£60,000	Buildings, machinery, etc.
65,000	£1 Ordinary Shares . . .	65,000	Stock
		5,000	Preliminary expenses
		10,000	Cash at bank and in hand
		<u>£125,000</u>	<u>£125,000</u>

The meaning of preference and ordinary shares was explained in Chapter XX. What this statement shows is that the shareholders have subscribed £125,000. £5,000 of this has been spent on forming the company, and must be recovered out of future earnings. The rest has been used as previously described.

The company now begins operations, and its managers are immediately faced with a whole set of problems.

(a) What will it cost to make a chair, if we make 500 a year; or 1000; or 10,000?

(b) How many chairs can we sell for five shillings each; for ten shillings each; for one pound each? And how many people can afford new chairs, and will they want to?

(c) What wages ought we to pay our staff?

(d) What are we going to do with our profits, if we earn any?

(e) What voice, if any, should our shareholders or our workers have in the way we conduct the business?

(f) Besides ourselves and our troubles, how many other people are making chairs? And are their troubles greater or less than ours? And if so, why?

What does it cost to make a chair? The answer lies in two great laws, which seem contradictory but are not really so. The first is the law of diminishing returns. This was originally applied to agriculture. If you do a certain amount of work on a field, you will get a certain crop. If you double the amount of work, you will not get double the crop, and ultimately there comes a point where no amount of extra digging, manure, etc., will increase the crop. The same applies to a machine. Work it at a certain speed, and it will turn out so many chair-legs. Increase the speed of operation beyond a point, and it will begin to spoil its work and soon wear itself out. Quite apart from humanitarian considerations—which should take first place—it applies to workers. Work a man twice as hard as before, and even if you don't knock him up, he will not do twice the amount of work of the same quality.

The second law is that the more machines the company uses, and the more it succeeds in using all of them up to but not beyond their proper capacity, the less does it cost to make a chair. To see why, it is necessary to consider what expenses the manufacturer has to incur, and how far they vary with the number of chairs made.

The following are the main expenses:

- (1) Wages of operatives.
- (2) Raw material.
- (3) Power.
- (4) Administration expenses.
- (5) Buying, selling and distribution expenses.
- (6) Rent.
- (7) Rates.
- (8) Interest on capital.
- (9) Upkeep of factory and renewal of worn-out machinery.
- (10) Insurance.

The following notes on each item will illustrate the truth of the second law.

(1) *Wages*.—If the factory were employing one man to make a chair at a time by hand, it would be employing a highly skilled and therefore expensive man to make chairs by a very slow process. If it employed many men in the same way, most of the cost would remain, and in addition it would have to pay foremen, inspectors, superintendents, etc., to see the work was done properly. If now it gives each man a complete set of machines to make chairs with, but still leaves each man to go through all the processes of chair-making, the man will need less skill and make more chairs in a week, and the savings so effected will outweigh the cost of the machines and the power needed to drive them. Still even that is not the best way of doing things. If efficiency and economy of work is the sole object, it is best to give each man or group of men and machines one particular process to perform, and then to pass their work on to the next group. Thus one group, or "department" as it is called, might cut the timber into rough shapes of the right size. The next might fashion the chair seats, or turn the chair rails, another department would put the chairs together, another would varnish them, and so on, till the final group packs them and despatches them to the factory's customers. This is the principle of modern "mass production". Each department handles *all* the chairs made in the factory, but only does a little bit of the work on each.

Now, it is clear that unless every department can be kept working up to its full capacity, men and machines will be standing idle. To the factory, this means waste, and waste of this kind is an expense, which must be added to the cost of such chairs as are turned out. It is true that some of the men may be paid "piece-rates", that is, if they do less work, they draw less money, and it is also true that men can be turned off if work is slack. Still, even allowing for this, it is clear that when the factory is working at capacity, the wage cost per chair will be at its minimum.

(2) *Raw Material*.—Up to a point, this cost is directly proportional to the number of chairs made, for if more chairs are turned out, more wood, varnish, etc., is used. Still, the factory buys cheapest if it can buy its supplies in large quantities and at regular intervals, so offering to the timber merchants a sure and steady demand. So that here, again, working to capacity reduces the cost per chair.

(3) *Power*.—The argument here is much the same as in the case of raw material. If, as is often the case, one big engine drives all the machines in the factory, it must be kept running even if only half the machines are working. It may consume less coal, but its driver and attendants do not cost less.

(4) *Administration Expenses*.—Most of these must be met, even if the factory is standing idle. They do not increase much, even if the factory is working to capacity.

(5) *Buying and Selling*.—Buyers, salesmen, travellers must be employed, and advertising expenses met, even if production falls off. In fact, it is just when sales are bad that intensified selling efforts are needed.

(6) and (7) *Rent and Rates*.—Rent on the land occupied by the factory, and rates (even after "de-rating") must be paid, even if the factory is closed down. They are no greater when the factory is working to capacity. Even if the land is freehold, allowance must be made for the interest on its purchase price.

(8) *Interest on Capital*.—This is less easy to deal with, but clearly interest on bank loans, debenture stock, etc., which must be paid regardless of the company's profits, ought to be regarded as part of the cost of production. Dividends on shares, whether preference or ordinary, are not so simple. In one sense they are only paid out of profits, and so are not part of the costs of production. Against this, the promoters of the company, when deciding whether or not chairs can be sold at a price equal to the cost of production, will naturally take into account the fact that they can only raise the

£125,000 of capital needed in the enterprise if they have the assurance that they can pay on the shares the minimum dividend required by the prospective investor.

We have already seen that capital requires a certain rate of interest if it is to be accumulated and invested. Provision of this interest is in one sense part of the cost of production, exactly the same as wages to the workers. In another sense, however, as dividends need not be paid if circumstances do not warrant it, interest on capital is not part of production costs. In any case, surplus dividends, over and above the minimum rate required by the investor, are certainly not part of production costs. They are a form of "rent" in the theoretical sense of the word, which is dealt with subsequently.

If interest on capital is part of the cost of production, it clearly has to be paid, whatever the output of the factory the capital has been used to build.

(9) *Upkeep and Renewals*.—Machinery wears out after a certain amount of use, and even if standing idle grows obsolete after a period of time. Buildings need painting and cleaning, whether the factory is working or not. In some cases, as with blast-furnaces, it is such an expensive matter to close down and reopen plant that it may be cheaper to run for a time at a loss. In general, this item varies very little with the output of the factory.

(10) *Insurance*.—Fire insurance has to be paid, whether the factory is working or not. Personal insurances, such as workmen's compensation, health and unemployment vary with the number of workers, and the incidence of their cost is much the same as that of wages.

The relation of output to production costs can be put very much in the form of an algebraic equation. If C is total cost, and n is the number of chairs produced in a year, it is not true to say that—

$$C = kn, \text{ where } k \text{ is a constant.}$$

The equation is more of the form:

$C = a + kn$, where a and k are constants.

In this case, the cost of producing *one* chair is not k , but $k + \frac{a}{n}$.

Cost accountancy to-day is the elaborate branch of accountancy which deals with the question of how much it costs to produce a single article in a modern factory, working in the way described. Space precludes any detailed description, and only two broad definitions can be given.

Assuming that the equation $C = a + kn$ is true, and this is a very sweeping assumption, k is called the "direct cost", which is linked definitely to each chair produced, and a is the "on-cost" or "overhead cost", which is independent of each chair produced, and must be shared among all the chairs produced, however great or small the number may be. It is the inevitable existence of on-cost which explains why it is that the greater the number of chairs produced, the less it costs to make a single chair.

CHAPTER XXXI

Sales problems—The laws of demand—Man's relative needs—Elasticity—Producers' and consumers' goods—The manufacturer's problems—Competition—The consumer's view—And the producer's—Theory and practice.

THE next question the company has to answer is, how many chairs can we sell in a year at a given price? This introduces a totally different set of considerations to that of the question of the cost of production, though clearly the cost of production depends on sales, simply because output must be governed by sales: for chairs made, but not sold, bring in no money. In other words, "the more we sell, the more we make; and the more we make, the less each one costs us. Therefore, sell cheap if that means selling many."

Now a man buys a chair because he wants it. And because most men have not an unlimited supply of money, the average man only buys a chair because he wants it more than something else. Again, the more the chair costs him, the more other things he will have to go without, and so the less likely is he to choose to buy the chair instead of something else. Next, there are certain things he must buy before chairs. For example, he must eat, so he buys food in preference to chairs, even if he has to eat his meals standing up. On the other hand, if his income is doubled, he will not buy twice as many loaves of bread. He is far more likely to buy two chairs, for himself and his wife. Yet, to complicate the position still more, he will buy one loaf of bread a day, while a good chair may last him a lifetime.

It is now necessary to lay down some rules to bring law and order into this rambling discussion. There are three of these laws:

(1) A man does *not* start by dividing up his expenditure into headings of food, light, fuel, clothing, housing, furniture, luxuries, etc., all of which have *equal* precedence. The necessities of life, such as food, clothing, housing, fuel and light, have *first* call on his income. Furniture, perhaps better food and clothing, have next call on what is left. Absolute luxuries have *last* call on what is left, if anything. Savings probably levy their toll all along the line, but little is saved out of the first call, and much out of subsequent calls.

(2) There are certain things, such as food, that people must buy, whatever their price. If the price of food goes up, people go without other things, not food. Thus the demand for food remains pretty much the same, whatever its price. In such cases the demand is said to be "inelastic".

Conversely, there are other things which people need not buy. Here a rise in price kills demand, and a fall in price stimulates it. Demand here is said to be "elastic".

(3) A man spends part of his income, and saves the other part. The part he spends goes in paying for goods which are consumed on the spot, or rapidly worn out. The part he saves, he either uses in buying a house or furniture to last him for his lifetime, or else invests, say, in our chair company, where the money is used in building and equipping the factory. This distinction introduces the conception of consumers' goods (*e.g.* a loaf of bread) on the one hand, and of producers' goods (*e.g.* a lathe) and capital goods (*e.g.* a house) on the other hand. The important point is that individual expenditure governs the demand for consumers' goods, and savings govern the demand for capital goods and partly for producers' goods.

Now to put these various sets of considerations together. It all comes down to this:

Until the factory is being worked to the limit of its capa-

city, the more chairs we make the cheaper we can sell them without going bankrupt. But to decide how many chairs people want to buy, we must reflect (a) how much money people have to spend; (b) how many more chairs will we sell if we lower the price; (c) whether or not they buy chairs out of savings; and (d) how many other things they will buy before chairs.

The answer to (a) depends on the general course of trade. The busier people are making and doing things for their fellows, the more they will be able to claim, among others, upon us to make chairs for them. The answer to (b) is that they must have some chairs, whatever the price, but that once a house is reasonably full of chairs, no reduction in price will sell many more. The only help it will give is that old chairs may be turned into firewood a little sooner. The answer to (c) is mostly, but not entirely, "yes". The answer to (d) is food, clothing, heat, light, houses. Furniture probably comes next.

This is the furniture manufacturer's answer; and every manufacturer ought to put to himself the same sort of questions, even though in every case the answers would differ. The best question to take next is that of the fortunes of other furniture makers. This introduces the whole problem of competition. On this there is much to be said on both sides.

To the consumer—and we are all consumers—competition is up to a point an unmixed blessing. Just as people run their hardest in a race, whether against their friends, the police or a bull, so does competition make each manufacturer, trader and shopkeeper try to turn out better goods at cheaper prices than his neighbours. If only one factory was making chairs, or even if the trade as a whole were only turning out just as many chairs as the public would buy at the price the trade fixed, then there would be little incentive to make good chairs and to sell them at a reasonable price. It is because more people are seeking to make chairs

for their fellows than their fellows really need, that the world at large can pick and choose the best chair at the lowest price, that is in return for the least amount of service rendered by the buyer. Proof of this is found in the fact that a monopoly or a well-established business with few competitors is always liable to run to seed.

The producer naturally takes a different view. Leaving until later the whole question of foreign competition, first of all he argues with some justice that for people to be making more chairs than are really needed is economic waste, and the benefit to the consumer is only a partial compensation. Next, the law of overhead costs teaches that one big factory can make chairs cheaper and more efficiently than can a lot of little factories all independent and working against each other. This, he also urges, suggests that competition is not an unmixed blessing to the consumer. Finally, he says that competition of this kind means periodic unemployment for his workers, and this again is economic waste and also reduces the purchasing power of the community.

Wherein lies the truth of these many arguments? The answer lies partly in human nature. Man, so far as he thinks of these things at all, not only loves efficiency, but loves freedom. He hates being only able to buy his chairs, or his tables or anything else from one big combination at prices fixed by that combination, and he would rather put up with a certain amount of "economic waste" if he could thereby keep his freedom. He repeats the rule laid down previously that no one has a right to make chairs, or rather that a particular manufacturer's right depends solely on the will of the consumer to buy his chairs rather than someone else's. This may not mean a perfectly ordered world, but, then, would a perfectly ordered world be worth living in? It is here that the extreme Capitalist and Socialist find themselves in company together up against human nature.

We have said "so far as he thinks at all". The truth of the

matter is that neither producer nor consumer, seller nor buyer, think these things out very much, and this is one reason why economic theory is often imperfectly fulfilled in practice. What the maker of chairs usually does is to say to himself, "The usual price of chairs is 10s. I can make them for 9s., and that is good enough." And he will go on selling them for 10s. for months and months, until he finds that he is selling none at all, and then will simply cut the price to 9s. 6d. and have done with it. Again, all the time, he may or may not know whether it is costing him 9s. or 10s. or 11s. to make a chair.

Nor is the consumer much better. If he is used to buying chairs at a certain price at a certain shop, as often as not he will continue doing so, even though cheaper and better chairs can be had round the corner. And knowing nothing about the theory of elasticity of demand, he will go on buying a new chair every year if once he has got into the habit of doing so.

CHAPTER XXXII

Stimulating demand—Advertising—New markets—Instalment selling—
Its danger.

THE next point to be dealt with is the ways in which demand can be expanded. Obviously, for a business to reduce its costs and obtain a greater margin of profit, it is necessary for the sales of its product to be increased to the full capacity of the factory. In so far as the demand of a product is elastic, we have seen that a reduction in price can mean a greater reduction in costs and so widen the margin of profit. If lower prices mean greater sales and so permit a greater output, it follows that they reduce the cost of producing each unit. Also, the bigger the production and sales, the less profit is required on each article to maintain the total profits at a constant level. Yet even when demand is inelastic it is one of the main duties of those responsible to do what they can to increase demand.

Advertisement is now recognised to be one of the chief ways to do this. Originally an advertisement simply gave information; for example, it would tell people who wanted to buy furniture where this furniture could be bought for a certain price. The next stage came with the growth of competition between firms engaged in the same trade. And here the duty of the advertising expert was to persuade the public that "So-and-so" makes the best chairs or the best soap. The next stage is designed to overcome an inelastic demand. This consists in persuading the public that life is not worth living without plenty of chairs or soap or any other com-

modity. This merges in the final stage which has been in evidence during the past few years. This is the stage of collective advertising where all the firms engaged in a particular trade agree to issue joint advertisements, such as "Eat more fruit" or "British cars are best". Publicity to-day has become a necessary adjunct to modern business, and is one of the things that every manufacturer and trader must consider. Unless carried to extremes it can literally pay for itself, simply because of its reaction upon the total sales and overhead costs. If a firm by the use of advertisement can double its output, thereby making a large reduction in its cost of production, the consequent savings finance even a larger publicity campaign. On wider grounds modern publicity is less easy to justify. So long as it does no more than give the consumer full information as to how best to fill his needs, it is performing a definite and necessary economic function. When it hypnotises the consumer into spending money on things he really does not need, then it is in danger of doing definite economic harm. Even so, however, it must be remembered that life itself and the standard of living are and ought to be progressive; the old saying that the luxuries of to-day are the necessities of to-morrow possesses a sound element of truth.

Another way in which the manufacturer can increase his sales is the time-honoured way of tapping new markets. New markets are found at home as well as abroad, as witness the recent history of the motor industry. Twenty-five years ago motors were sold solely to the rich and nobody else could afford them. Since then some progressive manufacturers have deliberately centred upon producing cheap cars in large quantities, and on selling them at prices which can be paid even by those with moderate incomes. This, perhaps, is one of the most striking examples in recent business history of the way in which a new market has been tapped. It is an equally striking example of the operation of the law of overhead costs.

Another modern development which has greatly widened the demand of all sorts of articles is that of instalment buying. A producer is very rarely held up for lack of liquid cash. In the first place he raises his capital by the issue of shares, and secondly, he often buys his raw materials on credit. If he wants more money he can issue debentures or obtain a temporary loan from his bank, and in general he knows how to make use of all the resources of modern finance. Until recently the consumer has possessed none of these advantages, and yet, unless consumption balances production and unless the buyer can operate as efficiently as the consumer, an unbalanced state of affairs is going to arise which will be just as prejudicial to the producer as to the consumer. It is this that is at the back of much of the talk about consumers' credits that was in evidence a few years ago. Now, of course, it is idle to say that the producer only has been able to obtain credit. Every housewife who keeps a butcher's book instead of paying spot cash is obtaining credit. Her husband probably gets credit every time he visits his tailor, and every suburban bank manager knows how many overdrafts he has granted to his customers belonging mainly to the consuming class. Still, even this has hardly put the consumer on the same terms as the producer, and in late years the latter has come to realise that this inequality is one of the factors that restrict demand.

A remedy devised for this is that of instalment selling whereby the article is not sold either for spot cash or for credit on some indefinite terms, but is sold on terms embodying the payment of a fixed instalment at regular intervals for a term of months or even years; and of course the terms provide that by the time the purchaser has paid the final instalment, he has paid in the aggregate not only the actual price of his purchase but also an additional sum by way of interest. In some cases the producer finances instalment sales to his customer himself, but the usual practice is for the producer to make arrangements with some

finance company which specialises in this kind of business. In such cases the finance company will pay the producer the full value less an agreed charge, and in return the producer will pay over to the finance company the instalments as he receives them, and will also undertake to impose such terms upon his customers as the company thinks desirable.

Instalment selling has been subjected to much criticism and even abuse, but, like most other things, it all depends how it is done. It can clearly be carried to excess, especially when various firms are competing between themselves for the same customer. Cases have been known in America where a man with a moderate income has bought a house, his furniture, his car, his gramophone, his wireless set and so on, all on the instalment system, and has then found that he has engaged to pay monthly instalments amounting to more than the total of his monthly salary. This is the weak side of the system. Again, instalment selling should be confined to goods of a durable nature. It would be absurd to allow a man to pay for his Sunday joint in weekly instalments extending over a whole year. It is undesirable if not unknown for a man to be allowed to buy on the instalment system clothes which may wear out long before the instalments are complete. On the other hand there is no obvious objection to the system being applied to houses and furniture, which are bought to last a life-time, or even to motor-cars, which ought to last at least several years.

There is one other danger in the system. It is that it creates a fictitious atmosphere of prosperity. When trade is good, employment is active and wages run high, and there is every inducement for a big increase in the number and volume of instalment transactions. Now supposing that one big industry suffers a set-back, and consequent loss, wage reductions and unemployment. This might well mean a breakdown in the instalment payments of those engaged in that industry. This would react right through the whole commercial system of the country, and might possibly pre-

capitate and accelerate a general collapse. This danger was brought to notice by several authorities in America soon after the system had there become general, but it has yet to be proved how serious it is.

In broad terms instalment selling is really reduced to this. There is no objection to machinery which permits of an individual obtaining from his fellows goods and services in advance of those services he is going to give in return, provided that the machine does not permit him to obtain more goods than he is going to repay, and provided that there is reasonable certainty that he is going to continue to be in a position to make due payment. Instalment selling is but one part of the machinery for facilitating the exchange of goods and services. This consideration must continually be borne in mind when deciding whether it is a good or a bad system.

CHAPTER XXXIII

Profits—Their arithmetic—The trading account—The profit and loss account—The balance-sheet—The nature of profit—Their allocation—Losses—How they arise—Effect of price changes—Other miscalculations—The real function and risk of a business.

RETURNING to the new chair factory, wages and control can be left for the moment. Meanwhile, let it be assumed that the directors of the furniture company answered all their questions correctly, and at the end of the first year had made chairs in such a way and sold them at such prices as to leave them with a profit. What is a profit, of what does it consist, and what is done with it?

What is a profit? If in 1929 your property was worth £100 in money, and in 1930 £110, obviously you have made a profit of £10. But while measured in money, a profit does not necessarily consist of money. Return to the original balance-sheet of the company, given on page 152. Here the company is shown as worth £125,000, less £5000 already spent, or £120,000 net, and the shareholders own between them buildings, stocks and cash to the value of £120,000, or £5000 less than they subscribed.

Now assume that during the first year the company made £300,000 worth of chairs, and that it sold £280,000 worth, of which £260,000 worth were paid for during the year, while the remaining £20,000 was left owing. Assume, on the other hand, that it spent £280,000 on all its expenses, but that it had only paid £265,000 of this in cash and had £15,000 of this owing to its creditors at the end of the year. Finally,

assume that its stocks of raw materials were maintained at £10,000. What has happened?

Accountants answer this question by drawing up two sets of statements. One is the profit and loss account for the year, and the other is the balance-sheet or statement of the company's assets and liabilities at the end of the year.

Accountants as a rule prepare various profit and loss accounts, the earlier of which are submitted only to the directors and are not published. The earliest would be called a trading account, and might take this form:

TRADING ACCOUNT FOR YEAR ENDING 31ST MARCH 1930

<i>Dr.</i>			<i>Cr.</i>	
Wages . . .	£140,000		Chairs made . .	£300,000
Power . . .	10,000			
Raw material . .	90,000			
Administration .	28,000			
Rent and rates .	2,000			
Maintenance and re- newals . . .	5,000			
Other expenses .	5,000			
Balance carried down	20,000			
	<u>£300,000</u>			<u>£300,000</u>

This shows the directors how the company spent its £280,000, and that it made £300,000 worth of chairs.

The next point is that the company will have to pay income tax on its profits. This it is found will come to £4000,* and this sum must be set aside. So a new account is prepared:

<i>Dr.</i>			<i>Cr.</i>	
To income tax re- serve . . .	£4,000		Balance brought down	£20,000
Balance, being net profit and loss .	16,000			
	<u>£20,000</u>			<u>£20,000</u>

* When these accounts were compiled, income tax was 4s. in the £.

profit does not consist of cash, for the company's bank balance has simultaneously shrunk from £10,000 to £5000. Then what does it consist of? It consists partly of debts owed to the company which may or may not be good, and partly of unsold chairs which may or may not be sold for the £20,000 they were valued at above. And finally, the factory may or may not be worth in 1930 the £100,000 paid for it in 1929. In short, the £16,000 net profit is nothing more than a more or less honest and intelligent estimate of the directors and management, and in any case does not consist of cash. The same arguments apply, of course, to the balance-sheet, for the two stand or fall together.

The directors now have to decide what they are going to do with the profit. Are they to distribute it in dividends to the shareholders, or are they going to keep it back? Now, dividends have to be paid in cash, of which the company only has £5000. Therefore, if it is going to pay out more than this, it must either do some debt-collecting or else raise a loan from the bank. Again, one of the assets is preliminary expenses, which represents nothing more than money spent a year ago.

So the directors would probably say something like this:

"We have £16,000 of profits. We will pay the preference dividend, from which we will deduct 4s. in the £ income tax. We are bound to do this by law, and in any case we have £4000 income tax to find ourselves. Six per cent on £60,000 is £3600, and of this £720 we deduct for income tax. So we allow £2880 for preference dividend. This, if approved, will be paid in cash out of our £5000. We will use £5000 to wipe off preliminary expenses, and we will use £7000 to start the company's reserve fund. The remainder we will carry forward."

They then incorporate in the accounts a statement showing proposed allocation of profits:

Net profit for year	£16,000
To 6% Preference dividend (<i>less</i> tax)	£2,880
To Preliminary expenses	5,000
To Reserve Fund	7,000
Total	£14,880
Balance carried forward	1,120

This statement, together with the balance-sheet, are submitted by the directors to the annual meeting of the shareholders for their approval, at which the chairman of the board explains as much or as little as he thinks fit of the company's fortunes during the past year. He would probably explain the absence of an ordinary dividend, not by pointing to the shortage of cash to pay it with but by talking about the wisdom of conserving the company's resources. And he would receive a hearty and unanimous vote of thanks.

Now let us go behind the scenes for a minute and recast the company's balance-sheet after these allocations have been approved and carried out. The balance-sheet would look like this:

<i>Liabilities</i>		<i>Assets</i>	
60,000 £1 6% Preference shares . . .	£60,000	Buildings, machinery, etc.	£100,000
65,000 £1 Ordinary shares . . .	65,000	Stocks	30,000
Reserve Fund . . .	7,000	Sundry debtors. . .	20,000
Sundry creditors . .	15,000	Preliminary expenses . .	nil.
Income tax reserve . .	4,000	Cash in bank and in hand	2,120
Balance of profit and loss carried forward . .	1,120		
	<u>£152,120</u>		<u>£152,120</u>

This is a brief explanation of how a company's balance-sheet and profit and loss account are put together. It shows the various forms that assets and liabilities take, and it emphasises the fact that profits do not necessarily consist

of cash. And so the company goes on, earning a profit one year, perhaps incurring a loss another year, and all the time witnessing changes in its balance-sheet similar to those recounted above.

How is it that losses arise? The answer is in many ways. The obvious answer is, when it costs more to make chairs than is obtained by selling them. Rising costs or reductions of selling prices by competitors may bring this about, or even restricted demand leading to forced restriction of output and the inevitable rise in production costs. There are, however, other answers. One is a change in the price-level. A chair, or any other manufactured product, is not made in a moment. The raw materials have to be bought, workers engaged and their wages agreed, fuel and power contracted for, the chairs actually made, and then at last sold; and even then the existence of stocks of unsold chairs shows that there is often a gap between production and sales. Now all the costs incurred are ultimately paid for in money, and the proceeds of the sales are ultimately received in money. Furthermore, the value of all the company's assets and liabilities are measured in money, and the company's accounts simply set out these money measurements.

Now suppose during the time needed to make and sell a chair the price-level falls by 10 per cent. Refer first to the trading account. The single credit item, namely, chairs made, only arises at the end of the period, namely, when the chair is completed. Therefore that is reduced by 10 per cent. On the other hand, few of the debit items can be so reduced. A fall in the price-level has no effect upon rent and no immediate effect upon rates. Wages, as we shall see, can only be adjusted gradually, with great difficulty, and after a long interval. The raw material was bought at the beginning of the period, before prices fell at all, and so too in all probability was the coal used to provide power. Administrative costs are largely salaries, and these are just as slow to move as wages. In short, the full brunt of the reduction falls upon

the credit item, and the debit items are but little affected. Simple arithmetic will show that a fall in prices turns a trading profit into a loss.

Nor is that the end of the story. Now refer to the balance-sheet. Plant and stocks are shown as worth £130,000. Can they still be sold for £130,000 after a 10 per cent fall in prices? Debtors are £20,000. If each paid 10 per cent less for his chairs, will they owe as much? Cash is shown as £5000. But this cash is the difference between receipts and expenditure, and if receipts are down by 10 per cent and expenditure unchanged, the difference will be less than £5000. Thus all assets are less than if prices had remained unchanged. Now take liabilities. The income tax reserve, it is true, will not be required if no profit has been earned, but creditors will still want paying, and we have already seen that the fall in prices will have had little effect upon expenditure. In short, the shareholders' property as represented by their original capital of £125,000 and their profit of £16,000 will have suffered a serious reduction.

A rise in prices has just the opposite effect. Expenditure responds slowly, receipts rise at once, and assets are worth more than they originally were, while creditors need be paid no more. In short, a changing price-level, while it is changing, has a very marked effect upon balance-sheets and profit and loss accounts. Once it has become stable, all items have a chance of readjusting themselves to the new level, though even this is a long process, but a rising price-level will add enormously to profits, while a falling price-level will involve even the soundest and most efficient undertaking in a loss. No wonder that industrialists prefer currency inflation to deflation. Even though profits earned during a period of inflation are largely artificial, in that they only represent paper money instead of genuine goods and services, the uninitiated are slow to realise this and are prone to buy shares in a company at prices equivalent to the inflated profits.

Nor are these the beginning or end of the effects of price changes. When prices are falling, the consequent losses drive firms into liquidation, turn men out of employment, and damp down enterprise everywhere. This means general stagnation and contraction of purchasing power, which lasts until prices become more stable and confidence returns. Rising prices in their turn stimulate a false atmosphere of prosperity, leading to greater enterprise and activity. This lasts for a time, and gives a spurious appearance of increased purchasing power. Ultimately, of course, the bubble bursts, and people see that their earnings and assets consist largely of paper. Then comes the crash.

Even apart from fluctuations in the general level of prices, the manufacturer is at the mercy of his own miscalculations or of special circumstances affecting his own industry. The chair manufacturer—especially if he is one of many, all working independently and in competition—may turn out more chairs than he can sell. If so, he finds stocks piling up in his warehouse and in his balance-sheet, until ultimately he has to cut his loss and sell his surplus chairs for what he can get. Again, new and more efficient machinery for making chairs may be invented and adopted by a competitor. In such a case, the manufacturer either has to re-equip his factory with similar machinery, or else continue operating at a disadvantage. Labour troubles, high rates, taxes, wars and threats of wars, all these are factors that may upset the shrewdest of calculations. The two facts the manufacturer, his workers and his shareholders are up against are these: Profits, assets and liabilities are at the best only an honest and intelligent estimate by the directors and management of the value of certain things in terms of money; and a factory can only operate by making its plans ahead, basing them upon the current business situation and its probable outcome.

To put this in its most general form, the object of a business, including its shareholders, managers and workers, is to join together in making for the community something which

the community needs and then exchanging it for their own needs. If the community does not need what they make, or if the community can get it on better terms from somewhere else, then the business and all concerned in it are left high and dry. It is this that explains capital losses and unemployment of workers.

CHAPTER XXXIV

Reserves—Their objects and consequences—Compulsory re-investment—
A typical balance-sheet—The fruits of big reserves—Reserves, share
values and dividends—Bonus share issues—Obtaining fresh capital—
Share issues on bonus terms.

To return to the balance-sheet and profit and loss account of the company. The example given included allocation to various Reserves, and it is important to understand just what these mean. Reserves are profits which have been earned by the company, but which the directors decide not to distribute in dividends to the shareholders, but to keep in hand either for some special purpose or in the general Reserve Fund of the company. They are not necessarily represented by cash, simply because profits themselves are not necessarily earned in cash.

A company accumulates reserves for much the same reasons as an individual saves part of his income. Four main reasons can be cited:

(1) As we have seen, a company may have earned a profit without having in hand the cash required for an equivalent dividend. Hence it allocates the profit to reserve for no other reason than that it is unable to distribute it. This difficulty is fairly common, but is usually overcome. A company of good repute, and with sound assets that will be realised shortly in the normal course of trade, can borrow from its bankers the cash required for a dividend. Some American companies have got round the difficulty by paying dividends in the form of bonus shares.

(2) A company establishes special reserves for various

defined purposes, *e.g.* impending income tax payments, provision for renewal of obsolete plant, allowance for the depreciation of certain assets, sinking funds for the redemption of notes and debentures.

(3) When times are good and profits big, most companies build up big reserves, so that dividends can be maintained even during bad years when losses are incurred. Many companies have a special reserve fund called "the dividend equalisation reserve" simply to serve this purpose.

(4) Over and above all these reasons, the establishment of a reserve fund means that the directors of the company are each year keeping back part of the profits and using them to extend the business. In reality the directors say to the shareholders: "This year we earned for you so much, but instead of giving you it all, we are making you re-invest part of it in extending the business". This policy of building up big reserves, which often grow to the size of the original capital, has many important economic effects. In the first place, it involves the shareholders in compulsory saving, for part of their income is never given to them by the directors, but is saved on their behalf instead. It equally involves them in compulsory investment, for the savings are invested in the business itself. The accumulation of reserves also means that there is a tendency for every business to grow automatically, without regard to whether or not the demand for its products is equally growing, and this is the weak side of the apparently sound policy of building up big reserves. Still, so long as the reserve fund, the business itself, its output, sales and profits all grow proportionately, it is clear that the dividend paid each year on the original shares will grow in the same proportion, and so too will the market price of the shares.

The directors of a company rarely consider all these points. A proper sense of prudence leads them to build up reserves, and a proper sense of enterprise tells them that the building up of reserves is the simplest way of obtaining the fresh

capital that they desire in order to extend their business. Ultimately the balance-sheet of our chair factory might look something like this:

BALANCE-SHEET, 31st MARCH 1930

<i>Liabilities</i>		<i>Assets</i>	
60,000 £1 6% Preference shares . . .	£60,000	Buildings, machinery, etc.	£180,000
65,000 £1 Ordinary shares	65,000	Stocks	50,000
General Reserve Fund	90,000	Sundry debtors. . .	35,000
Dividend Equalisation Reserve Fund	10,000	Investments . . .	20,000
Sundry creditors (including provision for income tax) .	40,000	Cash in bank and in hand	10,000
Balance of profit and loss	30,000		
	<u>£295,000</u>		<u>£295,000</u>

Here, by accumulating reserves amounting to £100,000, it has been able nearly to double the size of its factory and acquire some investments which can be realised in case of need. *Provided that it can sell its extra output of chairs*, it has nearly doubled its business, turnover, profits, dividends and everything—entirely by building up reserves.

Now compare the allocation of this profit of £30,000 with that of the original profit of £16,000. The preference dividend still requires only £2880, and in view of the size of existing reserves, £10,000 should be an ample allocation to reserves of all kinds. That leaves something like £15,000 available for ordinary dividends, equivalent to 23 per cent on the ordinary shares, and as all the way through these calculations it has been assumed that income tax has already been deducted, the real dividend on the ordinary shares is 29 per cent.

Next, what are the shares worth under these conditions? The preference shares still only get their 6 per cent, and all

they have gained is additional security, due to the big increases in assets and profits, on both of which they have first claim. The main factor governing the price of the preference shares is the general level of interest rates. Probably if 3 per cent could be obtained on bank deposits, and $4\frac{1}{2}$ per cent from Consols or Conversion Loan, the investor would require a yield of about $5\frac{3}{4}$ per cent on these shares; so their market price would be not quite 21s.

The value of the ordinary shares is less certain. The company has done well, and 29 per cent is a big dividend; and there are further possibilities. Yet even so, things may equally go wrong, and, to allow for possible risk, the market might well require a yield of 9 per cent on such shares. This would make their price 64s. 6d. The difference of £2:4:6. between this last figure and the pound the ordinary shareholder originally paid for his share, is a rough measure of the amount of money that his directors have compulsorily saved for him and invested in the business.

A further point that arises from these calculations is that the dividend of 29 per cent does not here imply gross profiteering. The sum actually paid in dividends is £15,000 plus £3750 income tax, or £18,750 gross. The ordinary shareholders' portion of the assets is the total of £295,000 less £40,000 due to creditors and £60,000 belonging to the preference shareholders; or a net £195,000. A dividend of £18,750 on property of £195,000 is not 29 per cent or anything like it, but only $9\frac{2}{3}$ per cent. These figures illustrate the anomalies that arise from attaching a definite par value of £1 to the ordinary shares.*

Is there any way of rectifying the anomaly? There is one way which is very frequently adopted by prosperous companies. This consists of the "capitalisation of reserves" and the issue of "bonus shares". To do this, the directors propose, and the shareholders confirm, the issue, say, from reserve "of one £1 ordinary share for every ordinary share

* Cf. p. 113.

now held". The ordinary shareholders receive these new shares free, gratis and for nothing, and it costs the company nothing too. All that happens is that the ordinary capital is increased from £65,000 to £130,000, and the general reserve fund reduced from £90,000 to £25,000. Assets, earnings and profits all remain unchanged.

The rate of dividend obviously alters. The payment of £18,750 in dividends is no longer equivalent to 29 per cent, for it now has to recompense an ordinary capital of twice the size. The rate, therefore, drops to $14\frac{1}{2}$ per cent. This is much more in accordance with the actual facts of the case, and also removes any suggestion of profiteering.

It is well known that when a bonus share issue is impending, the price of the shares improves, but it is not easy to see why a purely book-keeping transaction—which is all that a bonus share issue really is—should have this result. The answer is firstly that the unthinking shareholder thinks he is getting "something for nothing", instead of merely nothing for nothing. There is, however, a better reason than this. Capitalisation of reserves marks the completion of a definite stage in the company's progress, and the fact that the directors are prepared to reduce their reserve fund suggests that they believe future misfortunes are less likely to happen. As we have already shown, sentiment plays a large part in determining Stock Exchange prices.

Of course, the price of the ordinary shares would no longer be 64s. 6d. Assuming that "sentiment" made the market now content with a yield of $8\frac{1}{2}$ per cent, the price of the shares with a dividend of $14\frac{1}{2}$ per cent would be 34s., and as the original holder of one share now has two, his property would have risen from 64s. 6d. to 68s. His year's dividend is unchanged in total amount.

To come now to a different problem in finance. Suppose that the company needs, in addition to its reserves, fresh capital from outside, what are the ways in which it can be raised? It will be assumed that no bonus share issue has been

made, and that the position of the company is as shown on page 179. Now there are several ways of obtaining new capital. First of all, money can be borrowed from the bank. This, of course, will only provide new capital for a short space of time, as bankers will not tie their funds up indefinitely in a company's plant and machinery. As a rule, a company only borrows from the bank for a few months while it is making arrangements to raise permanent capital elsewhere. Next, it can issue debentures, as explained on page 107. To a growing and prosperous company, which can be certain of meeting the debenture interest, this is often the cheapest way of raising new capital, and it has the merit of avoiding the need of letting in a crowd of fresh shareholders to partake of such plums as are going. On the other hand, debenture interest must be met in good or bad times alike. Finally, it can issue fresh shares for cash, these being either preference or ordinary.

Now, to issue fresh ordinary shares at par would clearly be unjust to existing shareholders. The dividend of 29 per cent is the fruit of the reserve fund of £90,000, which represents savings out of past profits. To admit new shareholders to partake of these fruits on equal terms with the old would obviously be unfair. So what is usually done is first to offer the new shares exclusively to existing shareholders, and secondly, to offer them at a price intermediate between the par of £1 and the market price of 64s. 6d., say at £2:10s. Thus, if the company wants £50,000 of new capital, it offers not 50,000 £1 shares at par, but 20,000 £1 shares at £2:10s. each. The ordinary capital is increased by £20,000 and the reserves by £30,000, the product of the premium of £1:10s. The ordinary shareholder thus has only to share his reserves with 20,000 instead of 50,000 new shareholders. Besides this he can either become the new shareholder himself, or else sell his "right" to the new shares for the difference between their issue price of 50s. and the market price of the company's shares of 64s. 6d. This gives him a windfall of 14s. 6d. per share.

CHAPTER XXXV

Losses—Writing down capital—Position of preference shareholders—And of ordinary shareholders.

THE company, of course, by no means always earns a profit, but occasionally incurs a loss. In such cases it naturally draws upon its reserve funds, for just as reserves are built up out of profits so are they eaten away by losses. It also, of course, has to sell some of its investments or draw upon its cash in order to meet such losses. For example, if a company with a reserve fund of £20,000 and investments of £25,000 incurs a loss of £10,000, it can deduct £10,000 from its reserve fund on one side of the balance-sheet and sell £10,000 of investments, deducting this amount from the other side. If a company goes on incurring losses after it has exhausted its reserves, the losses have to be shown on the right-hand side of the balance-sheet, and just as profits on the left-hand side represent the sum due to the shareholders, so a loss on the right-hand side of the balance-sheet represents the sum due by the shareholders. Again, if a company has all its reserves tied up in its business, for example, in machinery, etc., and has no investments to realise against a loss, it will have no alternative but to borrow money from a banker or elsewhere in order to meet the loss. That is why when a company shows a loss on the right-hand side of its balance-sheet it often shows a big overdraft or other loan outstanding on the left-hand side of the sheet as part of its liabilities.

Just as a company often capitalises part of its reserves

by issuing bonus shares, so in due course it often has to get rid of an accrued loss on its balance-sheet by writing down its capital. This, of course, is not a task to be undertaken light-heartedly. It consists of deciding that either the ordinary or both the ordinary and preference shares shall not be considered as being of £1 each, but shall be reduced to some lesser amount such as 15s., 10s., or even 5s.

The first step is to persuade the shareholders themselves that a drastic reduction in the nominal value of their holdings is really necessary. Next, the law provides that the leave of the Court must be obtained, *i.e.* that the proposed reduction must be approved by a judge, and he naturally needs satisfying as to its necessity. Yet, just as bonus shares issued from the reserve make no difference to the assets or profits of the company, so the reduction in capital does not pay one penny of the company's debts to outsiders, nor does it mean that the company is going to earn a profit in future. All it means is that instead of the nominal capital of the company being, say, £100,000 offset by a loss of £20,000 on the other side, in future the nominal capital of the company shall be only £80,000. So long as the company is passing through a bad time it is advisable to defer the operation of reconstructing or writing down its capital. Once the bad time is over and the directors are reasonably certain that it is once more going to begin to earn profits, then they can write down the capital to an amount determined first by the reduction needed to get rid of past losses, and next by the need of establishing a reasonable ratio between the new capital of the company and profits. Even then the question of paying all existing debts and raising adequate working capital remains, and this as a rule means the raising of fresh money.

Allied with this is the question of whether or not preference capital should be written down as well as ordinary capital. The principle of preference shares is that this class of shareholder shall not lose one farthing until the ordinary share-

holders have lost all, and if the preference shareholders insist upon their rights they can have the company wound up, its assets sold for what they will fetch, and the result distributed first to outside creditors and debenture holders, then to the preference shareholders themselves, and then to the ordinary shareholders if anything is left. On the other hand, preference shareholders frequently decide or are persuaded to surrender their rights and to share in the capital reconstruction. The argument frequently put before them is this. "If the company goes into liquidation and the assets are sold, they will realise so little at their break-up value as to leave nothing for the preference shareholders". The plant and machinery in a chair factory busy making chairs is obviously worth more than the plant machinery of a derelict factory, especially if that machinery is designed for making chairs and nothing else. This is the argument the ordinary shareholder usually employs, and frequently employs it with such effect that the preference shareholder has to make too big a sacrifice. There is one vital difference between the two classes of shares. The preference shareholder gets a dividend of, say, 6 per cent, which is based on the nominal value of his share. Thus if his share is reduced from £1 to 10s., his dividend is also halved. The ordinary shareholder gets whatever profits are left, and these remain the same whether the nominal value of the share is £1:1s. or 1d. Thus the writing down of preference shares involves their holders in a real loss of income. The writing down of ordinary shares, which own what is called the equity of the business, need not mean such a loss, or, indeed, a loss of income at all. In fact if both classes are written down, the net result may be that the ordinary shareholder gains at the preference shareholder's expense.

CHAPTER XXXVI

Subsidiary companies—Holding companies—New company law provisions
—Reading a balance-sheet—Some rough tests.

So far we have considered the case of a manufacturing company owned by individual shareholders and engaged in actual production. Companies, however, very frequently own shares in each other. A common example is that of the subsidiary company. The furniture company we have been discussing might have set up a separate company for the purpose of making and providing it with paint and varnish, or another company to attend solely to the marketing of its chairs, or yet another to control forests to supply it with timber. In order to keep the control of these companies and to ensure that they conform to its regulations, the furniture company would have to own more than 50 per cent of their share capital. It would then be able to elect such people as it liked as directors of the subsidiaries, and in general see that they did all they were told to do. Again, the furniture company might buy up a rival business which already possessed a well-known name and all the goodwill attaching thereto. In order to preserve the name, it might preserve the company in its entirety and exercise control solely by taking over the majority of its shares. This is another example of a subsidiary. Often when one company buys another in this way no cash passes at all. The purchasing company takes over the majority of the shares of the new subsidiary, and in payment therefor issues its own shares to the original shareholders of its new subsidiary.

The definition of a holding company is that it does not directly engage in actual production or business at all. Its assets consist simply of shares it owns in its subsidiaries, who are themselves the actual manufacturers, traders, etc. The holding company's profits are derived solely from the dividends obtained from shares in the subsidiaries, and its chief function is to direct its subsidiaries and see that they all work together to a common purpose. It is obvious that the ramifications between different companies, including holding companies and subsidiaries, can be very complicated indeed, and provide a fine opportunity for the unscrupulous company promoter who wishes to camouflage the true facts of the case. It has indeed been not unknown for a company to be floated, obtaining one lot of cash from the investing public, and then within a few years to float again three or four children, the birth of each child providing an opportunity for obtaining some more cash from the investing public. When the true state of affairs is published, it has been revealed that the same assets have been sold to the public three or four times over. It is for this reason that the law now provides that in every company balance-sheet shares in subsidiaries, money due by subsidiaries, and money due to subsidiaries shall all be shown separately.

Even so, it can be a very difficult matter to read a company's balance-sheet and profit and loss account in such a way as to see exactly how the company is doing. In the first place, as we have seen, the money value of many of the items in both accounts is no more than a more or less honest estimate made by the management, and that is why many authorities say that the first thing to look at in a company's report is the name and reputation of the several directors. The auditor's certificate should also be read carefully, especially to see if any reference is made to reservations, and here again the reputation of the accountants who act as the company's auditors must be taken into account. In addition there are one or two rough-and-ready tests that can

be applied to the actual figures. Few companies except railways publish their turnover or year's ratio of gross earnings to expenses, but it is obvious that such items as creditors, debtors, cash and stocks will, on the whole, rise and fall with the amount of business being done. So if an investigator takes a series of balance-sheets covering several years, and compares all these items separately from one year to the next, he can deduce that if all the figures are increasing in the same proportion, the company's business is also increasing. He can also gain useful lessons from movements in any one of these items as compared with those of the others. If our furniture company showed one year a big increase in stocks, it would be a fair deduction that the company was making more chairs than it could sell. If "sundry creditors" showed an increase, then either the company is on the point of launching out into fresh activities or is finding some little difficulty in paying its debts. When business is slack debtors may decrease and cash may actually increase, simply because the company has more money than it needs at the moment in the business. Another test is whether or not the company is getting "frozen up". Add together cash, debtors and stocks (though the inclusion of this last item is a matter of opinion) and take therefrom creditors, and the result, plus or minus, shows how far the company is able to meet its current engagements. Again, another rough test is to see how much the shareholders' property is "worth". To apply this, add up all the assets of the company, excluding such intangible items as preliminary expenses, accrued losses and other purely book-keeping entries, and also assets earmarked for some particular purpose such as redemption of debentures, etc. Then deduct from this total all liabilities to outsiders, including those to the staff and to debenture holders. Compare the final result with the issued share capital of the company, and this shows the shareholders' position.

To add one final word of warning, it must be remembered

that every balance-sheet is simply a photograph of the position of a company on a particular date. It may or may not be a fair representation of an average day in the history of the company.

CHAPTER XXXVII

Organisation and costs—Wage costs—Advantages of co-operation—
Regulating output and prices—Some objections—Rationalisation.

So far we have considered the average company which operates on its own or possibly with subsidiaries, and in general acts as an independent unit. Now the whole trend of modern industry is in the direction of organised production, so as to reduce working costs. Experience has shown that the simplest ways of reducing costs are not always best. For example, some manufacturers still have the idea that the only way to reduce costs is to reduce the wages paid to their workers. Ethically this is the last expedient that should be tried, but even apart from this consideration it is subject to two great disadvantages. The first is that it leads to frequent disputes and strikes, and in the long run may cost the manufacturer far more than he has set out to save. Secondly, it has the great disadvantage of reducing demand. Obviously, if all wages were forced down to the level where they left their recipients no money with which to buy furniture, our chair factories would suffer even more than the wage earner, and if the chair factory is unable to sell chairs it will not want to buy timber, plant, machinery, coal and everything else it needs. Thus, apart from ethical considerations, the policy of reducing wages is a double-edged weapon, and the majority of enlightened manufacturers are to-day learning to reject it.

Wage costs can be reduced in several ways without reducing wages. If the chair-manufacturing company can re-

organise its system of working so that the same number of workers can turn out double the number of chairs, obviously it has cut its wage costs in half. It can even offer to pay higher wages and yet effect a considerable saving. The same applies to all other costs besides wages; if by reorganisation it can turn out double the amount of chairs in the same factory, it has cut in half all such costs as rent, rates and the maintenance and upkeep of the factory. Finally, the manufacturer is learning to-day that one of the best ways of reducing costs is to co-operate with other undertakings engaged in his trade instead of competing against them. Co-operation can be made to extend over the whole field of buying, manufacturing, selling and finance, and this movement towards co-operation is perhaps the most prominent post-war industrial development.

In its elementary forms this co-operation often took the wrong direction. It concentrated too much upon output, sales and prices, and the guiding principle was that of reducing output by agreement with the sole object of obtaining better prices. Thus both at home and abroad organisations called cartels and rings have been formed, the members of which agree with each other that each shall only produce a given quantity and shall not sell below a minimum price. Some of these cartels possess very complicated rules. Thus the total production of all the members of the cartel may be fixed at a definite limit, and each member will be allocated a certain quota or percentage. If he produces more than that quota he pays a fine into the common fund of the cartel, while if he produces less he may receive a bonus. Now in its extreme form this is nothing more nor less than a conspiracy to fleece the consumer, and in such cases there is clear justification for such legislation as the anti-trust laws of the United States. Apart from this, limitation of output is in direct contradiction of the modern principle of reducing costs by increasing output to the utmost capacity of each undertaking. The only justification for schemes of this kind

is where excessive competition has brought about over-production far beyond the consumers' maximum needs, with the result that some form of regulation is needed. This is the argument advanced by those who in 1929 instituted marketing schemes for the British coal industry, and who to-day have as an ultimate object the conclusion of international agreements between coal producers of various countries. Even so, this conception has one great fallacy. It assumes that the consumer's need for coal has a fixed and unchangeable limit.*

The other and more healthy movement is that known technically by the unwieldy name of rationalisation. Rationalisation, so far as it means anything at all, means concentrating all kindred undertakings under a common direction with the object of making production as efficient as possible. It is co-operation in the truest sense of the word. Cartels and price rings and output regulation schemes are not rationalisation. The financial unification of various companies is not rationalisation, though obviously financial unification is the first step. The ultimate aim of rationalisation is the re-allocation of the various processes in the industry between the various undertakings existing in it in such a way that each undertaking performs that process for which it is best fitted by circumstances. Thus, if the furniture industry were rationalised, the factory in our example might concentrate solely upon making chairs or even the backs or legs of chairs. Another factory, formerly its competitor, might concentrate on tables. The raw materials for all the factories, both chairs and tables, would be bought as a common operation, and the same unification would take place at the selling end. The whole object of rationalisation is increased efficiency of operation as expressed in lower production costs.

* Also consider the 1929 Coal Bill, introduced since this paragraph was written.

CHAPTER XXXVIII

Wages—Their origin and meaning—Employer and worker—Sharing the risk—How wages are paid—Time-rates—Piece-rates—Fixing wages—Labour as a commodity—Its limitations—The worker's position.

So far we have left on one side one of the most important questions in industry, and that is the question of labour and wages. What we have assumed hitherto is that the furniture factory we have been discussing has to employ labour and has to pay wages. We have now to see what is the meaning of wages, how wages are fixed, and, in general, the whole part played by the worker in the economic machine.

We began by saying that the whole basis of life was exchange. Each of us makes certain goods or performs certain services for our fellows, and we are paid for them in money which we in turn could use to buy goods and services for ourselves. Originally each man would work on his own account, one man growing food, another making clothes, and so on, and he would sell the proceeds of his labour for what he could get. It soon became apparent that two or more men working together could produce more and so earn more than if they worked independently. From that it was an easy stage to the system under which one man could, perhaps through greater skill or greater knowledge or even greater enterprise, build up a business for the supply of some particular product of his neighbours, and engage others to help him in his business and to work under his orders, for in any common enterprise it is necessary that one man should direct, and the others obey his orders, as otherwise chaos

will follow. Now consider the position of the men who are working for the founder and owner of the business. They are still making goods or performing services for their neighbours. For example, they are equally making clothing or furniture whether they are working on their own account or whether they are working under the orders of someone else. The difference lies in the way in which they are rewarded for the fruit of their labours. The man working for himself has to exchange his product for what he can get. The man working for somebody else leaves the actual exchange of the product to his employer, and his own remuneration is fixed between his employer and himself. It does not depend directly on the terms on which his employer conducts his exchanges with the rest of the community, though obviously there is a close connection between the two.

This introduces a new conception, and that is the sharing of the risks of the trade as between an employer and his worker. An employer engages to pay the worker a fixed wage, regardless of passing successes and failures of the sale of their joint product. If sales are good, the employer obtains more. If sales are bad, he may not even obtain enough to meet his wage bill, and will have to meet the loss out of his own pocket. In short, the risk falls in the first place upon the employer. This does not mean that the workers have no share in the risk. If sales are bad, the employer may say to them that either he must close down his business and leave them to find other work, or else they must consent to receive less wages. The conception that the employer—whether it is a small shopkeeper or the big manufacturer—stands all the risk has been proved false over and over again. To go no further back than the past few years, the wage reductions that precipitated the coal stoppage in 1926, and the $2\frac{1}{2}$ per cent cut made in railwaymen's wages in 1928, prove that the worker shares in the risk.

Wages are determined in various ways. First of all there is the system of payment by time. That means that a man

engages to work for so many hours daily or weekly, and in return he receives a given wage. He gets that wage whether he works hard or slackly, or even if he is sitting idle part of the time. Under that system it is up to the worker to do faithfully all work that comes his way, and human nature being what it is, the employer has the task of seeing that his workers stick to their job. This system is often modified in various ways. For example, it may be agreed that the employer can call upon his workers to work overtime, and this extra work is paid for usually at a higher rate than the ordinary day's work. On the other hand, the employer is often prevented either by law or by agreement from making his workers work more than a certain number of hours in the day or week. For example, work in the coal-fields is limited by law to a certain number of hours a day, the exact number being at present* a matter of much controversy between mineowners, miners and the government.

The next method of fixing wages is that of piece-rates. Under that system a man is not paid according to the number of hours he does, but by the quantity of his output, *i.e.* so much money per ton of coal mined, or so much for a given quantity of cloth woven. Theoretically this is the correct system, for the more the man can produce the more the employer has to sell, and, in short, the wage the worker gets from his employer corresponds with the quantity of goods he makes for his employer. In practice piece-work has several objections. Firstly, there is the temptation for the worker to scamp his work, and so just as in the case of the time wage system the employer has to exercise supervision. Next, the piece-worker can be more easily victimised or treated unfairly, for he can be penalised by the simple process of starving him of work, giving him the worst places in the coal-pit to dig coal in, or in general giving him jobs which take much time and trouble to perform with little to show at the end. Besides this there has long been a suspicion of piece-rates

* September 1929.

prevalent in the minds of the workers, because in the middle of the last century short-sighted employers saw that some of their men were earning large wages on piece-work, and promptly cut their rates. This attitude of mind is fortunately now becoming extinct. It is recognised that the more and better work a man can do, the better it is for his employer as well as for himself. The fundamental lesson of the distinction between wages and costs has now been learned, and it is known that a man can earn high wages and at the same time, owing to his greater productivity, work at a low cost to his employer. Idle men are as expensive as idle machinery, and low-paid workers doing inefficient work are as costly as obsolete and worn-out machinery.

In addition to these two main systems there are various minor modifications. For example, bonuses are paid if more than a certain amount of work is done. Wages are occasionally paid partially in kind, although this practice is regulated very carefully by law. For example, the farm labourer gets his cottage at a low rent, the miner is sold cheap coal, and so on. In some cases wage agreements are extremely complicated, being a mixture of piece- and time-rates, often with various percentage additions superimposed. Those who talk glibly about the level of wages in the coal industry are walking amidst numerous pitfalls. A curious example of the mixture of piece-rates and time-rates is found in the wages of signalmen. The signalman is paid a wage of so many shillings a week, *i.e.* on a time basis, but the wage rate was originally determined for each signal-box by the number of lever movements that the signalman made in an average day. This is one of the most curious examples of piece-work imaginable.

The next question to consider is, what is it that determined wage rates? Why is an agricultural labourer paid 30s. a week, a railway signalman in a second-class box 65s. a week, a clerk in a big office £100-£150, and a first-class civil servant £500 a year and upwards? Why are certain men deemed to be worth £10,000-£15,000 a year and others less than £100?

These are difficult questions to answer, and the solution of the problem they create is rightly exercising some of the keenest minds in the country. Some approach to the problem can be made by getting back to first principles, but the answer does not pretend to be a complete one. First of all, a worker has only one commodity to sell and that is his labour. It is a necessary commodity, but he is not the only one selling it, and at times the supply is greater than the demand. More than that, it is a commodity which will not keep. A man who is out of work and at the end of his resources needs work at once if he is to remain alive, and a promise of work in six months' time is of no use to him. Again, he cannot sell any kind of labour. A cotton-spinner would be of little use in a coal-mine, or an ironfounder in a stable. Even the driver of an express train would be at a loss if set to drive a motor-bus. In short, once a man has learned a certain trade he is to some extent confined to that trade, although the Americans have shown that it is far easier for a man to change from one trade to another than most Englishmen are ready to believe.

Again, if a man is tied to a trade he is still more tied to a locality. A man out of work and with no money is not in a position to move himself and his wife and family from one end of the country to another. This ties him in another way to a particular trade, for many localities are given over to one trade and one trade only. The miner in a Welsh mining village could not get a job as a cotton-spinner in South Wales, even if he were both able and willing to take it on. To that extent both by training and locality he is forced to remain a miner. This lack of fluidity of labour is an economic factor which deserves greater recognition than it often receives. In passing it may be observed that the same applies to capital. Once capital has been sunk in a coal-mine it cannot be diverted into a cotton mill. It does not, however, apply to the £10,000-a-year man. For one thing his wealth makes him mobile, and for another thing the qualifications of a big

industrial organiser, who can command a salary of these dimensions, are general enough to fit one industry as well as another.

Another point is that until recently the average worker did not have the knowledge or experience to deal on level terms with his employer. He had no understanding of the big forces that fixed for the employer the price he could obtain for his product, or which suddenly dried up the demand for the product of the particular industry in which he was engaged. All this meant that he was at a disadvantage in any negotiations over the rates of wages, and in self-protection he fell back upon the principle that, because a certain wage had been paid in a certain industry in the past, therefore he was not going to accept less in the future. This, of course, is a purely rule of thumb procedure and is open to many theoretical objections. The most that can be said for it is that up to a point it works.

CHAPTER XXXIX

Trade unions—Their main functions—Employers' associations—The trend towards national organisation—Some common mistakes.

OF late years the worker's position has been greatly strengthened. One reason is the growth of trade unionism. Instead of an employer being able to deal with each of his workers singly, with the underlying threat that if one does not take his terms he can easily find another, the workers have banded themselves into trade unions embracing firstly the workers in a particular district, and to-day all the workers in a single trade or a single group of trades. This means that the trade union can employ as negotiators on behalf of their members men who have just as much knowledge and experience as the employers themselves. This also means that the trade union can say to the employer: "If you do not accept our terms, it is not a question of depriving you of the labour of one particular worker, but of depriving you of the labour of all the workers in the industry".

The conduct of wage negotiations is not the only function of a trade union. For example, it acts as a friendly society for its members, administering their health insurance fund under the national scheme. Still, there is no question that the main purpose of a trade union is to deal with employers on behalf of its members. Recent history has shown that the progress of rationalisation and combination on the employers' side in industry has been accompanied by amalgamations between trade unions. Three railway unions several years ago united into the present National Union of

Railwaymen. The miners' trade unions were amalgamated first of all into district federations, and finally into the National Federation representing every coal-miner in Great Britain. When a local question arises it is dealt with by the local branch of the union, but when a question of national policy, such as a general wage agreement, comes to the front, the whole National Union has to act. Employers, too, have their associations representing the whole of a particular trade, and the result is that a dispute to-day between employers and workers can often embrace the whole of an industry, while the political pressure that can be brought by a big employers' association or a big trade union can also be very considerable. Politics as such are outside the scope of this book and this is not the place to note all the relations between the trade unions and the Labour Party. The main point for the reader to realise is that the amalgamation and consolidation of industry is as much in evidence on the side of Labour as on the side of Capital.

So long as the trade unions keep up their main function of securing for their members the highest wages that the industry can pay, then there need be no quarrel with them. Unfortunately, zeal for the interests of their members has occasionally led trade unions into courses of action which are economically unsound. For example, in their anxiety to secure as much work as possible for a particular trade represented by a particular trade union, they have forced upon manufacturing undertakings rules saying which man can perform a particular class of work, and these rules in several cases have tended to become far too rigid and to hamper seriously the conduct of a factory. More pernicious still, attempts have been made by trade unions from time to time to limit the amount of work which can be done by any one man. Where the limit is justified by reasons of health or by the fact that unscrupulous employers are tempted to overwork their men, the trade union is performing a useful task, but when the object of imposing a

limit is simply to ensure that there is "enough work to go round", this misguided policy only results in defeating the object it sets out to attain. It is clear that where men are limited as to the amount of work they can do, wage costs will inevitably rise, and it is equally clear that the greater the costs the less will be the sales of the business, the output of the factory and the total quantity of work available. Economic history teaches, from the introduction of machinery onwards, that the more work a man can do, the less his work costs, and the more work will the factory have available in the aggregate. It is only fair to add that employers on their side have been known to resort to this practice of "ca' canny" in order to spread out work. Still, whichever side is responsible, this practice must stand condemned.

CHAPTER XL

Wages—Some general considerations—Wage-levels and demand—Agriculture—Railways and roads—Professional qualifications—Labour's lack of fluidity—A lesson from America.

IT must be confessed that no complete and satisfactory answer has as yet been given to the original question as to how the wages in any particular trade were determined. The ultimate factor determining the wage which is paid for any particular job depends upon how much the consumer desires the product of that job, and is prepared to pay for it. This rule is a very rough-and-ready one, for as we have seen wages and wage costs are not the only factors governing the total cost of production, and it may well happen that ignorance on the part of the workers may lead to their accepting wages lower than those this rule would warrant. So, alternatively, it is not unknown for wages to rule too high. Still, in the long run the wages paid to a man in return for his labour will approximate to the level laid down by this rule, and there seems no fundamental argument for refusing to believe that wages are not determined by any other factor. In short, a worker is really selling his labour directly to his employer and indirectly to the consumer, and his wage is in the long run determined by supply and demand, just as is the price of butter or bacon. Foreexample, the farm labourer's wages in England are 30s. a week. They are fixed by law, and farmers complain that even this low rate is higher than the industry can stand. If this is true, the reason is that farmers elsewhere can raise crops more cheaply or more

efficiently, and that the consumer naturally buys his food in the cheapest market. Even this is not the end of the story, for it is at least arguable that the high costs involved in British farming are due not only to wages but to causes, such as taxation, the British system of land tenure, etc., which are outside the farmer's control.

Similarly, the reason that railwaymen's wages were reduced by $2\frac{1}{2}$ per cent in 1928 really comes down to the fact that unless the British railways were prepared to charge lower rates and fares the British public preferred either to travel by road and send their goods by road, or else to stay at home. The attempts of employers in the woollen industry to lower wages may very likely originate from post-war changes of fashion and the use of new materials such as artificial silk, all of which have decreased the demand for woollen goods. On the other hand, a first-class civil servant receives a wage many times that of a farm-worker, partly because before he can become a civil servant he has to have an extensive training such as to enable him to pass the entrance examinations. Were the pay and conditions of work in the civil service not made commensurate with this, it would be found that a sufficient number of new civil servants would not be forthcoming. The same applies to many other professions, and even the high salaries paid to men at the head of big businesses are due to the fact that the demand for the £10,000-a-year man exceeds the supply. Whether any man can be worth £10,000 a year to a business or not is beside the point. What really matters is that the business thinks he is worth that figure to them, and therefore they are prepared to pay it.

It is obvious that complete equality of wages and salaries in different trades and professions is not possible, simply because the demand for the products of various trades, and the price the consumer is prepared to pay for those products, are continually varying both between one trade and the next, and also from one moment to the next. On the other hand,

the number of men necessary to work at a particular trade is not definitely correlated with the demands for the product of that trade. Labour, as we have seen, lacks fluidity, and this alone is one reason why it is difficult to make the supply of labour in a trade match the demand for its product. In short, when a man sells his labour he has to make the best bargain he can, just as a man selling actual goods to the consumer.

The American worker has learned that if he is not contented with his pay, or with his conditions of work, it is far more effective to threaten to throw up his job and take a totally different kind of work in another part of the country than to go on strike. There is nothing an employer hates more than a continual loss of his best men, and their replacement by others who have to be trained from the start. This may seem a hard lesson to preach in England at a time when unemployment is severe, yet in bad times and in good the worker should realise that it is up to him to drive the best bargain he can and to sell his labour in the best market. The man who insists on remaining fixed to a particular trade will make the worst bargain in the end. Whether labour gets a fair share of the proceeds of industry, or whether labour is entitled to all the proceeds, are questions which are left over to a subsequent chapter.

CHAPTER XLI

The minimum standard—Trade boards—Real wages—Wages and prices—
Effect of a rise or fall in prices—Cost of hiring bonuses—The main
lesson.

THERE is, however, one more qualification to this chief argument concerning the level of wages. It is that wages paid in any particular trade must be such as to give the workers a certain minimum standard of life. Put in its most brutal form, if this minimum standard is not possible the workers in that industry will eventually die of starvation, and for this if for no other reason the industry will cease to exist. Fortunately, public opinion goes a little farther than this, and in certain trades where workers or their unions have not been strong enough to enforce the establishment of an adequate wage the law has stepped in and said that a certain minimum wage must be paid. The farm-worker's wage of about 30s. a week is one example of this. Another example is found in the establishment some twenty years ago of trade boards in certain small industries. These boards are appointed to determine the minimum wage that shall be paid in a particular industry, and failure by an employer to pay that wage is a criminal offence. In enforcing a minimum wage, what the community really says is this: "If your industry is not sufficiently profitable to provide its workers with a minimum standard of living, then we hold that it is against our conscience for this industry to exist".

This conception of the need for all wages to provide a certain minimum and hardly adequate standard of living is one that qualifies to some extent the general rule that the level

of wages in any particular trade is governed adequately by the same laws as those governing prices. This introduces the next aspect of wages. As we have seen, wages are paid in money. Yet every recipient cannot live on money but only on the things that money will buy. The money paid to him in wages is as much a medium of exchange as money paid and received for any other purpose, and what matters to the worker just as much as the money he receives is the quantity of goods he can buy with that money. This is the conception of the "real wage" as opposed to the "money wage", and it is the real wage, namely, the amount of goods and services that the money paid for a week's work will buy, that is the true measure of the terms upon which a man sells his labour. For example, supposing that the prices of all necessities of life double, while money wages remain unchanged. Then it is clear that the real wage of every worker has been halved. Political speakers are occasionally heard to argue that the minimum wage should be £4 a week. It would be perfectly easy to pass and enforce an Act of Parliament to this effect, but one of the first consequences would be that the prices of the necessities of life, in themselves the product of labour, would rise in much the same proportion, with the result that real wages would be the same as before, and all that would have happened would have been the wholesale dislocation of the nation's economic life.

Another and more pertinent example is that of the effects of big changes in the price-level. Supposing that the price-level rises in the course of a couple of months by 10 per cent, and money wages remain unchanged, then real wages will have been reduced by 10 per cent, and assuming that the national output of goods and services remains the same, the effect of the increase in prices will be that the workers lose a tenth part of their share. In general, when prices are rising rapidly, workers' real wages are on the low side, because it takes time to negotiate and enforce an increase in wages above what both employers and workers have both long

regarded as the conventional and agreed level. Also, if prices go on rising, by the time the first increase in wages has been agreed upon, the second increase will have become due. Conversely, if prices are falling real wages will be raised, simply because this time the delay in making wage changes favours the worker. In this case, however, the employer will soon find that wage costs have become higher than the trade will bear, and that unless he can negotiate a decrease, he may have to shut down and throw his men out of work. Unfortunately, it is never easy to persuade workers to accept lower wages just because the price-level has fallen. The first psychological effect on the worker and his wife of a fall in price is the realisation that at last they have a greater margin in hand than they had before. It is only human nature that they should not see why they should surrender this margin to their employer by accepting a reduction in wages. This is another reason why falling prices are bad for trade, in addition to those dealt with in Chapter XXXIII.

Immediately after the war, when the price-level was fluctuating violently, an attempt was made by many enterprises to make wages vary with prices, the actual instrument being the official cost-of-living figure. Every month the Ministry of Labour publishes an index figure measuring the average level of retail prices of the necessities of life, and workers and employers in many industries agreed that for every rise or fall in this index the equivalent percentage changes should be made in all wages in the industry. This was a rough-and-ready attempt to keep constant the level of real wages, and it undoubtedly prevented serious disputes from arising in many trades at a time when retail prices and the cost of living were fluctuating violently.

In any case, the main lesson of this last section is that the workers' remuneration for his labour depends just as much on what his money wage will buy as on the actual money wage he receives. If a 5 per cent increase in wages means a 10 per cent increase in the cost of living, it is not worth having.

CHAPTER XLII

The control of industry—The small business—Its development—"Management"—The manager's predominance—His relations with the directors.

WE have discussed the financial side of modern industry, and have seen how profits are earned and distributed or how losses are incurred and dealt with. We have also considered wages, and have made a partial attempt to see how they are determined. The next point to be considered is one that to-day is in some ways the most important of all. It is that of the control of industry.

So long as business was conducted upon a small scale, the owner, the employer and the manager were synonymous terms. Even to-day, the small country shopkeeper owning one shop and employing perhaps two or three assistants is owner, manager and employer all in one; and the same applies to the small speculative builder or proprietor of a laundry or sawmill. In these cases, it is the same man who puts up the capital, engages and gives orders to the workers, and who takes the profit and has to meet the loss. Even where ownership and control is divided, as it often is in a small business, between two or three active partners, these three terms remain synonymous.

To-day, however, is pre-eminently the day of the big business, in which hundred of shops, or mills and factories employing thousands of workers, are grouped together under a common ownership and control. Ownership, too, is to-day seldom concentrated in a few hands, for the development

of the limited company has, as we have seen, enabled the savings of the multitude to be collected and invested in a common enterprise. The change from the small to the big business has, it is true, been a gradual one. Fifty years ago, a single individual or two partners may have founded a small business, which they themselves controlled, and in which they knew personally every one of their small band of workers. As the business prospered and needed fresh capital, they turned it into a company, and so ceased to be partners and became directors. For a time they might keep the management in their hands; they might even own themselves a majority of the shares and so retain control. Then after a few more years they would grow older and wish to retire, and so would appoint a paid manager to do the active work, and content themselves with laying down general lines of policy at the weekly or monthly meetings of the board of directors. The business, too, would have grown to the point where neither the directors nor the general manager could know every worker in the business. An intermediate hierarchy would come into being. The first grade in this would consist of the main departmental heads, such as the works manager, who would control production and the factory; the sales manager, who would organise sales; the accountant, who would be responsible for all financial matters; and the secretary, who would be the immediate servant of the directors, and also be the link between the company and its shareholders. Each head in turn would have a lesser hierarchy of his own. Thus, each shop or department in the works would have its own chief, taking his orders from the works manager and giving them to the workers under his control. Nor would even he give them direct. Between him and the main body of workers would come all the superintendents, inspectors and foremen, who form the next grade in the hierarchy of a modern factory.

Even this is not the final development of modern business. We have traced the development of the small individual

business into the big company. We have seen that in between the shareholders who are the real owners and the main body of workers come all kinds of intermediaries such as the directors, the general manager, the departmental heads and the general body of chief clerks, superintendents and foremen. Yet this is not the end. The final stage is the amalgamation of three or four of these companies into one big combine, controlling perhaps a substantial proportion of the whole of one industry in the country, and operating factories in many districts. The amalgamation may be made by welding together the constituents into one big company, with a single board of directors and one chief general manager responsible to the board for the entire activities of the company. More often a holding company will be formed, so that each of the constituent companies, which now become subsidiaries, are no longer directly owned by individual shareholders or "capitalists" at all.

This is a far cry from the small privately owned business with which this story started, and this development of "big business" has called into existence a whole set of new problems. The fundamental point to realise is that the division of the business world into "owners" and "workers" is no longer true. To "capital" and "labour" must be added a third partner, "management", and it is the third partner that more often than not is cock of the roost. The shareholder, it is true, still puts up the capital, takes his profit or stands his loss, and, in short, bears the risk that is an essential element in all industry. It is still true to say that the workers sell their labour to the company, and that the company sells or fails to sell its product to the consumer. What has changed is that in practice the shareholder no longer has the immediate control. All that the shareholder does is to elect the board of directors, but even this election is largely automatic, certain directors retiring every year and being promptly re-elected by the shareholders. When things go wrong, of course, the shareholders can and do refuse to re-

appoint the board, but as a rule the shareholder both possesses little control and fails to exercise it.

Nor are the directors in much better case, though this may be partly their own fault. A man is often a director of a dozen or more companies, and spends his life travelling from one board meeting to the next. He cannot be conversant with every detail of every one of his companies, and in practice does not try to become so. The result is that while in theory the management take their orders from the board, in practice the board usually meets to receive the reports of the manager and to ratify his decisions. Here again, it is only when things go wrong that the board step in and override or even replace their general manager.

The general manager, in his turn, cannot concern himself with detail. He issues orders much like the commander-in-chief in the field, but he leaves their detailed execution to his subordinates. And so on, right through the hierarchy, till the lowest grade of all is reached.

CHAPTER XLIII

The worker's position—The soullessness of modern industry—Lack of opportunity—Some causes of industrial unrest—The shareholder's position—Some current problems—The business as the economic unit—Sharing knowledge—And control—Works councils—Copartnership.

Now, how does all this affect the worker? It means, first of all, that he is but a cog in the machine. It may be a more efficient machine, and even a more humane machine, than the small private business of a generation or two ago, but it is also more bureaucratic and soulless. Details, of which the directors and general manager are ignorant, concern him, the worker, intimately and directly. His engagement, his dismissal, his conditions of work and his treatment by his immediate "boss" are all details to the directors. They are far from details to him. The fact is that while a big modern business organisation may be more efficient and even treat its workers more humanely than many small employers do, yet to the average worker it seems a soulless institution. His life consists of clocking in at 7 or 8 or 9 o'clock, or whatever the appointed hour is; of doing one job over and over again until his lunch hour; and then clocking in again in the afternoon with exactly the same kind of work until it is time for him to go home. All this time he takes his orders from those who, in their turn, are the victims of the machine. Occasionally, and oftener than he realises, he can take pride in his work and there is scope for his natural gifts, but too often his work is purely mechanical, and once he has learned how to do it nothing more remains for him. Moreover, all the

time he has little knowledge of how his particular job dovetails in with the rest of the machine. He dimly realises when times are good or bad, but if and when he suddenly finds himself faced with a reduction in pay, or even dismissal, he has no knowledge of how or why these misfortunes have occurred. The very men who direct the machine are either unknown to him or else are pure names; he has no personal contact with them. Nor can he hope to rise very far. Now and again a fortunate man may rise from the bottom right to the top, but such pieces of good fortune are few and far between. Finally, he knows that there are fortunate people in the business, both directors and managers, who are paid by the business more in a single year than he can hope to earn in a decade.

It is not only the disparity between the income of the rich man and the poor man that is at the bottom of much of the industrial unrest to-day. A potent cause is this feeling on the part of the workers that they are allowed no more interest in the business than to do their day's work, draw a week's wages, and be dismissed summarily if and when necessity arises. Again, as already pointed out, there is the feeling that he can never rise to the top. That opportunity was denied to him in his childhood when his parents, workers in their turn, were unable or unwilling to give him the general education necessary to qualify him for high grades in the modern big business. That feeling possesses a large measure of justification, and unfortunately it is still true to say that in many businesses the opportunities to qualify for the higher posts are reserved for boys whose main qualification is that they are the sons of their fathers. So long as the lack of education, favouritism, or nepotism denies a fair opportunity to the majority of workers in an industry, industrial unrest will continue.

The shareholder in his turn is equally fettered. A fact which the workers to-day fail to realise is that if few workers can ever hope to become managers, few shareholders can

hope to become directors, simply because directors of a company are chosen automatically from among a few big shareholders, and even from men whom the management think would make suitable directors. In short, the weakness of a big modern organisation is that those who have the real control of the business share least in its attendant risks. Failure means to the worker unemployment, and to the shareholder loss of dividends and the depreciation of his property. The manager, who is most responsible for failure, may incur none of this loss.

On the whole, managers of the average business do their work well, but there are to-day several pressing problems awaiting solution. The first is that of the recruitment of the managing class, and here it is still by no means certain that the best men are obtained. The field of entry is still too narrow, and men often rise to the top of the ladder by seniority or favouritism or sheer luck rather than by merit. Luck, of course, is always an element in success, and men always obtain their reward by watching for their opportunity and seizing it. Seniority at the best is only a partial measure of a man's ability, and favouritism is no measure at all.

The next problem to be solved is a more complex one. The big modern business, having thousands of shareholders and employing thousands of workers, is to-day as much an economic unit as the political unit was in the past. Means have still to be found of giving every member of the unit a definite interest in its fortunes and a definite share in its prosperity. One very important point is that few people in the unit know exactly what is going on. The worker is told nothing, and many managers still hold that he is not entitled to be told anything. The shareholder is told very little. He has the company's report of the balance-sheet, which incidentally the worker can read in certain newspapers, but the report and balance-sheet together give but a bald summary of the year's results, and in reality give just as much or just as little

information as the managing directors like. So long as competition between one business and another can exist, it is possibly a delicate matter to give every member of the unit, whether shareholder or worker, complete information, simply because the danger of leakage to a rival business is so great. Yet even so, it is worth considering whether this chance of leakage would not more than be offset by the better spirit that would exist inside the unit if every member were given the full confidence of those responsible for his fortunes.

The other question is that of control. In a democratic political unit the government is carried on by ministers and representatives elected by all the members of the unit. It is impracticable for the control of a big business to be vested directly in shareholders and workers, with the right to question each decision as soon as made. The general manager of a big business is in much the same position as a commander-in-chief in the field. He has to issue his orders, and they must be obeyed without question. Yet modern industrial thought is getting to see that as regards certain aspects of a business the workers can be given a direct voice. In many big businesses to-day works councils are elected. Such a body consists of representative workers, and they meet the management on level terms and discuss with them such matters as wages and conditions of work. It has been proved that this gives workers the definite feeling that they are part of the business with the right to be consulted, and at the same time it does not detract from the powers of the general manager and those in authority under him. This development is still a fresh one and is hardly spreading as rapidly as it should, but it is one of the most hopeful movements of recent years.

Finally comes the question of how far the workers should share in the profits of their business. The old conception was that the owner of the business took the risk of profit or loss, and therefore received all the profits. This conception was

never entirely true, because loss to the owner meant unemployment to the worker, and so the workers always took a definite share of the risk. To-day there has come into existence the new idea of copartnership, according to which the workers are given a definite share in the profits of the business. In some cases a definite class of shares are created which are issued to workers alone. The great argument in favour of this plan is that the workers possess a definite share in the ownership of a business, but against this there is the objection that if the business fails the workers not only lose their jobs but lose their savings invested in the business. In other cases a definite proportion of the profits are set aside for distribution among the staff, the share of each member depending upon his position, wages and length of service. Which is the better method has still to be proved, because the whole idea is still new. The important point to realise is that it is the big business which is the modern economic unit, and that all shareholders and workers are members of that unit and should as far as possible be given a member's privileges and rights.

CHAPTER XLIV

Land and rent—Differences in site values—Economic rent—The original conception—Interpretation of production costs—Actual rent—The lessee's standpoint—The elements in actual rent—Landlord's services—Capitalisation of rent—Applications of the rent theory—To industry—And to salaries—Rent as a margin—How it varies—How far rent is equitable—The remedy of taxation.

IN a previous chapter we discussed tentatively some of the reasons why wages and salaries vary so much between different trades and professions, and the results reached were inconclusive. Our next task is to return to these problems and to consider why it is that there are such great diversities between the rich and the poor. It is obvious that no final answer can be given. The problem is one that has always perplexed the minds of all. It is clear that complete equality is an impossible ideal, and it is also clear that there is no short cut towards raising the standard of living for the poor. For example, if the minimum wage were fixed at £4 per week, the effect on production costs would be such as to produce a corresponding increase in the cost of living and so leave real wages much as they were before. In order to see how these big inequalities of income arise it is necessary to introduce a new factor in the industrial machine and also a new economic conception. The new factor is that of land and the new conception is that of rent.

With the possible exception of shipping, every industry needs land for its factory and offices. More than that, there is only a certain amount of land to go round, and an industry cannot put up with any land. A factory could not be suc-

cessfully established in the middle of the desert of Sahara, or even five miles from the nearest railway. Unlike raw material and products of industry which are interchangeable, land is not. One Ford car is as good as the next, but one field or factory site may be far worse than its neighbour. It is these facts which help to determine what is to be paid for the use of land, whether for a farm, a dwelling-house or for a factory.

Rent, in the general use of the word, is the money paid by a tenant each year to the owner of the house or the owner of the land, but rent, in the narrow economic use of the word, has a very different meaning. A century ago economists were greatly concerned as to what fixed the rent of a particular farm or field, and a famous economist, Ricardo, finally came to the following conclusion: Let it be assumed that there are several fields, each growing wheat. Differences of soil, situation, etc., will give a different degree of productivity, *i.e.* to obtain a given crop from one field in a particular year will need more work to obtain it than from another. Now, the price of wheat at a given moment is independent of the particular field the wheat happens to come from, or the amount of work required to raise it. The cost of raising the wheat on the other hand varies with the amount of work required, and so varies from one field to the other. Clearly, with wheat at a given price, there will be some fields that yield a large margin of profit, others where the cost of production just balances the return, and others again where wheat can only be raised at a loss. The margin of profit was defined by Ricardo as determining the true economic rent of the land.

The cost of production must be interpreted in the widest sense of the term. It must include not only the farmer's expenditure on labour, seeds, etc., but also fair remuneration to himself for his own labour and for the capital that he has sunk in the farm. In other words, rent is not really part of the cost of production at all. It represents the toll

levied by the landlord on the margin between the cost of production and the selling price of the product, and it is the existence of this margin that enables the landlord to levy the toll and the farmer to pay it.

The right to levy this toll depends ultimately upon the law of the land. A state of society is conceivable under which any occupier of land can have the right to remain there and refuse to pay rent. This conception of rent is not only applicable to agriculture. Different sites have different values to the manufacturer. A factory adjoining a main line of a railway clearly has to pay higher rent for the land it occupies, simply because its proximity to the railway cheapens transport costs, which form part of production costs. This law applies in a slightly different form to shops, and even to dwelling-houses. A shop in a centre of a town or in a fashionable street will attract more custom than one elsewhere, while the house agents' slogan of "a stone's throw from the railway station" is well known to every householder.

The next question is, from exactly whom does the landlord obtain his rent? This is not an easy question to answer. *Prima facie* the tenant does not lose by paying rent, for we have already seen that his production costs, interpreted in the widest sense of the word, exclude rent. Similarly, rent is not an obvious burden on the consumer, for he is by hypothesis willing to pay the price of the product, and the price is determined by the cost of raising the crop on the least productive land under cultivation or the factory with the least convenient or practicable sites which do not yield any economic rent at all. On the other hand, when the manufacturer draws up his profit and loss account and calculates his total cost of production, he invariably and rightly from his point of view includes his rent as part of his costs. The householder looks on his quarter's rent as a very material item in his cost of living, and in general there is a very natural feeling that it is inequitable that certain individuals should enjoy huge incomes simply because their ancestors obtained

land which to-day happens to be in the middle of a big city.

Before deciding whether or not it is in the public interest that landlords should be permitted to levy rent, it is necessary to bear in mind one or two vital factors. The first is that the total rent paid by a farmer or any other occupier of land usually includes payment of definite services rendered by the landlord as well as the actual economic rent of the land. In England at least there is very little undeveloped land in which the owner has not sunk part of his capital. The owner of agricultural land has drained it, planted hedges, provided farm buildings, gates and so on; all this has entailed capital expenditure on his part, and he is as much entitled to interest on the capital he has sunk as is his cousin who perhaps has invested his capital in British Government Stock. Again, the landlord definitely undertakes part of the work of keeping the farm in good condition, and to that extent his rent is simply payment for that service. Similar arguments apply to the owner of a building estate who may have sunk capital in laying down roads and draining them. In fact, it often happens, and especially when agriculture is depressed and rents run low, that the total rent obtained by a landowner is barely equivalent to the proper remuneration for the services he has rendered in making the land fit for cultivation.

The other point to be realised is that land is continually being bought and sold, and the price at which land changes hands is governed largely by the rent it yields. Even if the rent paid on it by the occupiers of an estate may be excessive, it may equally be to the present owner no more than a fair return on the money he paid for the land judging by the current level of interest rates at the time he bought it. The real criminal, if that is the right term to apply, is the original owner who sold his land at an inflated price corresponding to his inflated rents, and he has already escaped for good and all.

Nor is it only to land that the doctrine of rent is applicable. The rent element can be found in the profits of successful undertakings and even in wages and salaries. The costs of production vary between different factories engaged in making the same article, and while one factory may have no margin at all between its sale price and production costs, another factory by reason of being able to operate on a lower level of costs may have a substantial margin. This margin is just as much economic rent as the rent of the farm.

The rent element comes into wages and salaries in a slightly different way. The argument is really similar to that of the shop in a fashionable site or the house next door to the railway station, but the conception that there is only a certain amount of land in existence also finds its parallel here. In every trade and profession certain men can do their work better than others. Managers have built up their reputations, and it is rightly or wrongly believed that if one of these be employed the return he will give will be far greater than that obtainable from a man without his qualifications. These men command a big price simply because it pays their employers to give it. The price may not always be justified, because a client will often engage a man with a big reputation simply because the man is well known and fashionable. This, however, is beside the point. The essential fact is that these men can obtain big salaries because others are willing to pay them.

Again, salaries and wages run high in particular professions and trades because entry into them is restricted. In many cases restrictions are necessary. Doctors have to undergo a special training and to show that their knowledge and skill comes up to a definite standard. The right of entry to many other professions also depends upon the candidate being able to pass entrance examinations. In other trades several years' apprenticeship is required with the same object in view. These restrictions are in one respect in the public interest, for they ensure that a minimum standard of

efficiency is maintained. On the other hand, they deny complete equality of opportunity and put followers of some professions in the position of enjoying a partial monopoly. At times, too, these restrictions exist for far less justifiable reasons. As we have seen, it is not everyone who can attain to certain heights in the industrial hierarchy. These restrictions on entry into certain trades and professions are clearly parallel to the fact that there is only a certain amount of land available, and this introduces the conception of rent once more.

To sum up, the profits earned by an industry and the dividends obtained by the shareholder are made up of three elements. First comes the ordinary interest on the capital invested, next comes the extra return needed to compensate for the risk of the capital being lost, and finally comes the rent obtained by the capital owing to the existence of a margin between production costs (including the normal and extra return on the capital) and sale prices. Wages and salaries are equally made up of three or four elements, though the dividing lines are by no means as obvious. Over and above the ordinary living wage, whatever that may be, comes the return on the capital sunk in the individual in training him for his trade or occupation, and finally, the rent element corresponding to his own particular qualifications or the advantages of position which he himself or his particular trade or occupation has established for him.

It must be remembered that the whole conception of rent is theoretical. Rent was first introduced by Ricardo as the best way of explaining why a landlord is entitled to charge rent for land simply because he owns it. Unlike other payments, rent is not a payment for a definite service rendered, for the landlord has not made the land, he has simply come into possession of it. The same idea occurs in all the other applications of the theory of rent, including those of wages, salaries and profits. Now, in theory we can separate the rent element from the other elements of wages and profits, but in

practice it is quite impossible, and in fact we are forced back on the more popular notion that when a man sells his product or his labour he obtains the best price he can get. Apart from this the time element must be remembered. The rent of a piece of land may be fixed for one year, or twenty years, or even 999 years. Fees, salaries and wages are to some extent fixed by convention and only altered at rare intervals, and the same rigidity is found even in the price of goods and services. On the other hand, the true economic rent of land or of anything else is subject to wide fluctuations at very frequent intervals, simply because it is the margin between true production costs and the selling price. Changes, too, in the price-level often have a vital effect upon economic rent. Leaseholders who entered into long term leases immediately before the war are to-day paying ground rents far less than those now current in respect of leases entered into after the war when money had lost much of its purchasing power. Thus, taking all these points into account, it is conceivable that in some cases the actual rent being paid is less than the true economic rent, while in others it is considerably greater. This last alternative is perhaps the more important of the two, for it means that rent has to some extent become part of the cost of production.

The final question is how far it is equitable that certain individuals should obtain in the form of rent large incomes for which they have not performed adequate service. There is little doubt that the great disparity of wealth existing in most civilised countries to-day is rightly causing much discontent, but whether it is curable is another story. The first answer to the question really reduces to a matter of arithmetic. The landlord of a big estate or the head of a big business may easily have an income running into five figures, but the actual burden that income lays upon each of that landlord's tenants or upon the consumer of each article produced by that business may be extremely small. In short, the burden, if it is fair to call it a burden, may be spread over so wide a

field as to exercise very little pressure on any part. The next point is that much can be done to allay the feeling of discontent by making rents the chief objective of taxation. This is being done to-day in Great Britain, for the heavy income and surtax imposed upon large incomes has the effect of intercepting a substantial portion of the rents and diverting them from their original recipient to the exchequer, and inasmuch as an appreciable proportion of the national expenditure is devoted to social services, as described in a previous chapter, the consequence is that by the action of the government rents are redistributed more fairly between the richer and poorer sections of the community. Finally, when deciding whether or not it is in the interests of the community to upset the whole economic and social system so as to make the existence of rent impossible, regard must be had as to whether such drastic action could possibly be successful, or whether it would not simply end in doing far more harm than good to the very people whom it was intended to benefit.

CHAPTER XLV

Unemployment — The fundamental cause — Miscalculations — Seasonal changes—Changes in industry—Rationalisation—The trade cycle—England's abnormal unemployment.

THE problem of unemployment is by common consent one of the most serious questions that the country has to consider to-day, and while no attempt is made here to suggest a cure, the causes of unemployment should find room for discussion in any modern book on economics. Fundamentally the cause is a very simple one. When a man enters a particular trade and seeks work in it, what he is really saying to the community is that he is willing to perform a certain service at a definite price. Now the community is not bound to accept that service or to pay that price. It may decide to go without, or to engage someone else to perform that service. Just because a man is qualified and willing to do certain work he has no right to force his fellows to accept it.

There are several reasons why certain services cease to be in request or why the price asked for them becomes unacceptable. One is miscalculation on the part of producers. As a rule production precedes sales, so that the manufacturer is employing his men on making goods which have still to be sold. Very often he suddenly finds that he has made far more goods than he can sell or hope to sell in the immediate future, and he is forced to shut down part of his plant and to discharge some of his workers. Such miscalculations are especially likely to arise in industries where many firms are competing one against the other in ignorance of

what each is doing. In such cases no one knows either the total output of the industry or the total demand for its product, and it is inevitable that at one time there should be over-production leading to unemployment, while at another time there shall be a shortage entailing the working of overtime. Whatever may be the objections to rationalisation and to big combines, it is to be hoped that one good result of the movement will be that the output of an industry will be more closely correlated to demand with the result that this cause of unemployment will be lessened.

Another cause of unemployment is that trade is subject to seasonal fluctuations. More coal is burned in the winter than in the summer, and in these days of small coal cellars few householders can lay in their winter's stock ahead and so even out the demand for coal over the whole year. Unemployment is always more severe in the building trade in the winter than in the summer, simply because long nights and bad weather restrict building during the winter months. Hotel-keepers and their workers are always busiest in the holiday months, while certain luxury trades are only fully employed during autumn when they are making goods in anticipation of Christmas. Agriculture is perhaps the most prominent seasonal trade, and the movements of the crops affect not only agriculture, but to some extent every trade in the country. It may be argued that some of these essential factors should cancel each other out. For example, activity in house coal trade should balance the inactivity in the building trade. In practice such cancellation is rendered impossible by the inability of workers to change from one trade to another. It is difficult for the same man to be a builder in the summer and a coal-miner in the winter.

Another factor is the gradual change that is always taking place in industry and in industrial processes. The invention of a new machine or of a new material may render obsolete an entire factory and force it to close down and discharge its workers. For example, the post-war development of the

artificial silk trade is very probably one of the causes of unemployment in the older textile industries. Even changes in fashion may cause unemployment. The length of a woman's skirt is a very serious cause of contention between the Bradford makers of dress material and the Leicester makers of shoes and stockings, and it is conceivable that the addition of a few inches on skirts would mean a substantial increase in employment in Bradford.

Rationalisation, though beneficial in the end to unemployment, is at first its cause. Its object is to increase efficiency and to economise in all the means of production, including labour. Ultimately, rationalisation should lead to lower working costs and therefore to a bigger demand, increased production and decreased unemployment, but when a rationalisation scheme is carried out its first result is the displacement of a certain number of workers.

Another cause is the continual ebb and flow of trade. Trade is never constant in volume, and there is a well-known theory that it moves in a regular cycle whose period is about five or ten years. During the first part of the cycle trade is gradually improving, production and employment increasing, and at the same time prices gradually rising. Everybody is full of hope and enterprise, and is launching out into fresh plans. Sooner or later the time comes when traders find that they have overestimated the potentialities of the position, and that production, spurred on by competition and inflated by the birth of new enterprises, has outstripped all possible demand. Bankers, too, find that the demands of their customers for accommodation have reached the limit of their own lending powers, and, indeed, that in many cases loans are being sought for purposes that are either frankly speculative or are to finance the production of goods for which there is no genuine demand. Then the tide turns. Confidence disappears, bankers call in their loans and raise their rates, surplus goods are thrown upon the market, and there is a general fall in prices and increase in unemploy-

ment. There follows a time of depression and despondency, until people find that pessimism in its turn is being overdone and that there is still room for enterprise and progress. Then trade enters upon the forward stage of the next cycle.

Trade is exchange, and employment depends upon demand more than upon anything else. If certain people lose confidence, they will be unable or unwilling to buy as much as they could before. This reacts upon others who in normal times supply them with their goods, and so depression spreads from one person to another and from one trade to another right through the whole community. Unemployment in one trade or in one centre means decreased purchasing power, and so produces unemployment and depression elsewhere. In the same way, if confidence and activity arise in one place, their good effects soon spread. In short, so long as trade varies from one season of the year to the other, so long as everyone is liable to miscalculate, and so long as we are all liable to hope and despondency alternately, some unemployment is inevitable. It is quite impossible that there should always be an exact balance between the number of men able and willing to do particular work and the amount of that work waiting to be done.

This, however, does not answer the main question now before the country to-day, for no one can say that the continued existence from one year to the next of a body of unemployed amounting to over a million is due entirely to the causes mentioned above. Another reason must be sought, especially because at the moment* England is the only country in the world faced with a severe unemployment problem. Various reasons have been suggested, for example, that this country is too densely populated; and that industry is conducted upon wasteful lines and has too many handicaps in the shape of redundant directors or shareholders drawing

* This was written in 1929. It was not true of 1930, when the world set-back in trade had created serious unemployment in other countries, including the United States and Germany.

too big profits. From other quarters it is urged that British production costs run too high; that the high level of taxation imposes too big a burden upon industry; and that English wages are higher than those in other countries. Monetary policy has also been attacked as one of the causes of unemployment, and foreign competition and the free trade system have equally been assailed. To understand some of these criticisms it is necessary to consider an important branch of economics which hitherto has been overlooked, namely, the relation of British trade to that of the rest of the world.

CHAPTER XLVI

Foreign trade—The analogy of a town—International discontinuities—
The balance of payments—Why countries import and export.

THE subject of this chapter has given rise to more loose thinking and controversy than any other branch of economics. Possibly the best way to look at the question of foreign trade is this. The individual lives by making goods and performing services partly for himself and partly for other people, exchanging them with others for goods that he himself needs and does not make. The factory or group of individuals engaged in a common task is only an adaptation of this principle, for the product of the factory is sold to other people and the proceeds divided amongst shareholders, managers and workers, as already explained. The next step is to consider a different unit or group, namely, that of the town. The average town may contain some half-dozen factories, possibly divided amongst several industries, and it will also contain shopkeepers, professional men, municipal officers and many other miscellaneous people. Each one of these is engaged in the familiar tasks, first of production or service and then of exchange. The process of exchange will to some extent be contained within the town. Thus the boot factory will supply part of its boots to dwellers in the town, the doctor's practice will lie wholly in the town, and so on. The town, however, will not be self-supporting. It will not, for instance, grow its own food, but will have to buy from outsiders. Its citizens may have to buy some of their clothing from outside, simply because there

may be no woollen mill or clothing factory inside the town. There will be other demands made on the town by outsiders. Some shareholders in the boot factory may move to the other end of the country, and their dividends will have to be sent to them. All the more prosperous citizens of the town will have to pay income tax, which will have to be remitted to the Exchequer in London. Conversely, the town will obtain certain payments from outsiders. The boot factory will sell a large proportion of its output to the rest of the country, and citizens in the town will have shares in companies operating elsewhere and will draw their dividends. In short, the citizens of the town exist not only by interchanging goods and services among themselves, but also by exchanging goods and services with the outside world, and so far as any particular citizen is concerned, it makes no difference to him whether he deals with his fellow-citizen or with somebody outside the town.

This argument can be applied to a larger area than a town, but when we come to apply it to the country as a whole, other considerations enter. A country such as England, or France, or even the United States of America, is economically a homogeneous area. It has a common currency, a common system of taxation and government, common traditions and modes of life, a common labour system and even a common standard of living. The moment the frontier is crossed, discontinuity arises, for a different set of conditions is immediately discovered. The more important differences between Great Britain and foreign countries are dealt with later on.

Notwithstanding such differences, the argument in one sense still applies. If the reader refers to the chapters on the foreign exchanges, he will find a table giving the various reasons why the citizens of one country buy and sell the currency of another. He will find, too, that in general an equilibrium between purchases and sales must exist, and that the moment there ceases to be an equilibrium, forces are set

in motion which tend to restore it. Just as an individual can in the long run spend or lend no more money than he is able to earn, beg, borrow or steal, so a country's power to sell its goods and services to foreign nations or recover money from them is governed by its willingness to buy goods and services from foreign nations, to lend them money or to repay its own debts. The foreign trade of England is just as much a matter of exchange as is the trade of Sheffield with the rest of England, or the daily life of any individual.

The country, it must be emphasised, is a collection of individuals. When we say that England imports from abroad so much cotton, wheat or mutton, what we really mean is that Englishmen buy that much foreign cotton or wheat or mutton, either because these articles are not to be had in England, or because by buying them from abroad they can obtain better value for their money. Conversely, Italy buys coal from England, firstly, because she does not produce coal herself; and secondly, because Italians think that British coal is better value for money than German or French coal. If any country fails to give good value for money, the consumer can up to a point dispense with its products. If we find New Zealand mutton too dear, our remedy is to buy Argentine beef. Immediately after the war, when many of the continental coal-fields had been destroyed by the fighting, British coal exporters, having the European market to themselves, ran up prices to a ridiculous height. The French and Italians decided that coal was not worth having at all at that price and immediately developed water power on an enormous scale; and the British coal trade has suffered for it ever since. The main lesson to learn is that foreign trade is a matter of exchange to the mutual benefit of both parties just as much as home trade is, or indeed the activities of a particular town or individual.

CHAPTER XLVII

British overseas trade since the war—Currency and exchange dislocations
—The problem of stabilisation—How various countries solved it—
Effect on British trade—Our monetary policy and production costs
—The burden of taxation—Its relation to debts—Wage disparities—
Debenture burdens—Effect of war damage and reconstruction.

WE will now consider in detail some of the forms taken by the discontinuity existing to-day between Great Britain and the rest of the world. First and foremost it must be realised that the financial upheavals of the war and post-war years have brought into existence disparities between different countries, and particularly between Great Britain and many continental countries, which even to-day are serious. Normally, such disparities tend to be minimised through the operation of the foreign exchanges and international price-levels. For example, a low price country will export more than she imports. This will attract gold to this country which will tend to force up its prices to the world-level. The present times, however, are abnormal. Some seven years ago, the currencies of most important nations were badly inflated, and the foreign exchanges and international price-levels were literally "all over the place". One by one the nations of the world emerged from this state of chaos, but each chose its own way of escape, which differed from that of the others.

The choice each nation had to make was something of this kind. "At the moment our internal prices are, say, six times what they were in normal times before the war. That is because we inflated our currency, restricted the export

of gold, and in general, abandoned the gold standard. Now the purchasing power of gold as measured by the dollar, which is still on the gold standard, is only two-thirds of what it was in normal times; that is, gold prices are one and a half times what they were before the war. On this basis, the foreign exchange value of our currency against the dollar should be one-quarter of its pre-war par value. In actual fact it is one-fifth. This gives our exporters a definite advantage in the world's markets. Before the war, an article cost the foreigner and ourselves each, say, 100. To-day it costs him 150 of his currency and us 600 of ours. But 600 of our currency only costs him 120 of his. That is, we can sell our article to him for 120 of his currency, whereas he cannot sell his own for less than 150. Thus we have an advantage of 30.

"We now propose to fix a new par of exchange. Shall we choose one-quarter or one-fifth? If we choose one-fifth, our exporters keep their advantage of 30, at least until our internal prices rise to the new parity of 750, which is five times the gold prices of 150. And while they are rising, our manufacturers will receive the usual stimulus provided by a gently rising price-level. On the other hand, if we choose one-quarter, our prices will not rise, and no further hardship will be inflicted upon our nationals in receipt of fixed money incomes, which already to date have lost three-quarters of their original purchasing power".

That is the choice each nation had to make. In actual fact, England, Italy, Norway and Denmark chose "the quarter". France and Belgium chose "the fifth". It is difficult to say which Germany chose, in view of the fact that her currency's original value had completely disappeared.

In England's case, the choice took the form of inflicting a slight disadvantage upon our manufacturers and exporters. At the time we made the choice, our prices were some 5 or 10 per cent above gold prices. Yet we deliberately fixed the new par of the pound against the dollar at the same point as the old par. This meant that our internal

prices and production costs had to be forced down by 5 or 10 per cent, plus any subsequent fall that might take place in gold prices themselves. Now as each nation returned to the gold standard and began to rebuild its gold reserves, the world demand for gold increased. This forced up the price of gold against other commodities, or what comes to the same thing, forced down the price of all commodities expressed in gold as opposed to paper currency. So that the subsequent fall in gold prices has actually taken place.

It has proved a very difficult matter to reduce British production costs in the proper proportion. As we have seen, it is neither easy nor desirable to reduce wages themselves, and recent English industrial history has proved this again and again. Wage costs, of course, can be reduced without lowering wages, but this involves some measure of rationalisation, and experience is showing that this is a slow process, and one that is not always undertaken in the right spirit or carried out in the right way. Again, it has undoubtedly made greater progress in Europe and America than in England, so that on balance we have lost from rationalisation abroad more than we have gained from it at home. Certain production costs, too, such as transport charges and local rates, are beyond the direct control of the manufacturer, and so here he can by himself make no direct reduction. The de-rating scheme was introduced to deal with one of these burdens, but though it is a move in the right direction, it is argued that its benefits are too widespread to be really effective and go to too many people who do not really need them.

Next comes the question of the burden of taxation in England in relation to that of other countries. This is a very vexed question, firstly, because there is grave ground for doubting if taxes on profits—such as the British income tax—are really a burden upon industry at all; and secondly, because the system of taxation varies so much between different countries that it is very difficult to make any

valid comparison. Still, this much can be said with some degree of certainty. England came into the war years before the United States, so that the burden of war debt interest is far greater in England than in the United States—especially as England is collecting no debts for herself from her late enemies and allies, but is only getting enough to balance her payments to America. The continental belligerents, it is true, came out of the war with large war debts to their own nationals, but the stabilisation of their currencies at a fraction of their post-war values has meant that the burden of their war debts has been reduced to the same fraction. Money borrowed by the government in francs at 25 to the pound has only to be repaid franc for franc, even if the franc is reduced to 125 to the pound, and to a fifth of its former purchasing power. The same applies to the interest on the debt, so that in this case the government has got out of four-fifths of its debt. The bondholder's loss is the government's gain.

Thus for one reason or another, the legacies of the war are laying a far heavier burden upon the British tax-payer than upon those of other nations; and Great Britain is carrying more and "heavier" passengers, in the shape of holders of war debt, who are drawing dividends from the Exchequer, than are many other nations. We cannot get rid of these "passengers" without breaking our word to them and repudiating the National Debt, and this would deal a mortal blow to our credit, our reputation and our trade. For all that, the burden remains.

Another disparity is that of wages.

England has for many years maintained a higher standard of living for her workers than that prevalent on the continent, and the war has widened that disparity. Now, it is by no means clear that a low standard of living increases a nation's competitive power in the world's markets, for if this were so, the nations of the East would be at the greatest advantage and the United States at the least, and it is notori-

ous that the converse is the case. Again, a high standard of living means that the workers can buy more, and this is of direct benefit to many industries. On the other hand, a manufacturer who has to pay twice the wages of his foreign competitor starts at an initial disadvantage, which he can only overcome by superior organisation and management designed to translate high wages into low wage costs. America —and England too—have shown that this problem is not insoluble, but in many British factories it is still awaiting solution.

Again, currency depreciation and stabilisation at a far lower level helped continental industrialists in two distinct ways. Firstly, just as it allowed their governments to get quit of a substantial proportion of their national debts, so did it allow industrialists to get quit of their own debts, including debentures, and to start again with a profit and loss account free of most of their former debenture charges. Secondly, and this was especially true of Germany, when the currency was depreciating rapidly, it was the height of folly to keep huge cash balances, so manufactures invested every spare penny they had in new and up-to-date plant and machinery. In England, on the other hand, the appreciation of the pound involved manufacturers in actual loss and increased the burden of their debt. So they had to carry on in many cases with their existing and obsolescent plant through lack of resources with which to replace it.

The French and Belgian coal and iron industries obtained new and up-to-date plant in a peculiar way. These industries were largely situated in the battle areas, and their surface plant and furnaces were destroyed in the war. From the general standpoint the war represented so much loss and destruction, but the owners of the destroyed plant could regard it in a different way. What they could say to themselves was that the armies of three nations came along and obligingly scrapped for them their obsolescent plant without charging them a penny; while after the Armistice, the German

nation bore the cost of installing new and modern plant, again without charging them a penny. This may seem a strange view to take of the economic effects of the war, but in assessing the competitive power of industries in Belgium and Northern France it is a very pertinent point to bear in mind.

CHAPTER XLVIII

Remedies for British depression—The policy of inaction—Its objections—
Subsidies—Objections—Necessary conditions—Kinds of subsidies.

THESE are some of the causes of the present British industrial depression and large volume of unemployment. The next step is to consider some of the remedies that have been suggested. The first and simplest is to let things take their normal course. It is arguable that if other countries will supply us with goods more cheaply than we can ourselves, we would be foolish not to take advantage of this state of affairs, and that if our goods are so dear that the world cannot or will not buy them, we only have ourselves to blame. Moreover, if we continue to import and fail to export, we will lose gold, and continue to lose it, until the consequences of that loss force our prices down to the world-level. Trade depression and unemployment, it follows, are simply nature's way of forcing a cure upon us.

There are two objections to such a passive policy. The first is that gold movements and foreign exchange fluctuations arise from causes other than disparities in international price-levels and in the import and export of commodities. It is conceivable that if there was an inflow of foreign capital into British stocks and shares or of foreign short-money into the London money market, we might on balance be importing gold, even though our imports of commodities exceeded our exports. This suggestion is not entirely fanciful, for in 1928, a year of depression and unemployment, our imports of gold approximately equalled our exports. The other objection is

the humanitarian one. This so-called natural remedy will at the best take a long time to operate, and will inflict a considerable amount of hardship upon all engaged in industry and production. It is easy to talk about "economic pressure" in the abstract, but it is quite another story when you yourself are being "economically pressed".

Coming to more positive remedies, the first is that of subsidies to particular industries. This remedy has already been tried, and, as a rule, hastily abandoned. The classic example is the subsidy given to the British coal industry in 1925-26, the object being to avert the coal stoppage while the conditions of the industry were investigated by the Samuel Commission. The subsidy cost the tax-payer £23,000,000, and as the Commission's recommendations were rejected by the government, the only gain to the country was a respite of not quite a year.

A subsidy is a contribution paid by the State to those firms engaged in a certain industry, with the object of enabling them to bring their production costs down to a level corresponding to the world selling price of the goods they produce. Thus if the cost of producing a ton of coal is 21s., and the current price in the world's markets is 19s. per ton, the producer loses 2s. on every ton of coal he mines; and so long as this disparity exists, he will lose money until finally he has come to the end of his resources and has to close down. If he is given a subsidy of 2s. 6d. per ton, he can make both ends meet, sell at the competitive price of 18s. 9d. per ton and have a profit of 3d., which will be more than enough to enable him to carry on.

Now why is it in our example that the market price of coal is 19s. per ton, that is, 2s. less than the production cost? The explanation is that the coal producers in the world who are able and willing to mine and sell coal for 19s. per ton are sufficient in number to meet the demand for coal at that price. If the home coal industry cannot produce at that price, it means that for the moment it is both redundant and also

working on a more expensive and possibly less efficient basis than its foreign competitors. As we have seen in the case of England, an industry's high cost of working and even its relative inefficiency may be due to causes outside its control, and it may be that the low price and limited demand for coal are due to abnormal circumstances, and that in a few years' time demand will expand and prices rise until once more coal can be mined at a cost of 21s. per ton and then be sold at a profit. Still, for the moment, the disparity of 2s. is simply a symptom that the home coal industry is all or part of it redundant.

Now the circumstances described in this purely hypothetical example clearly make it an extreme step for the State to intervene and grant a subsidy. A subsidy, it must be understood, means that the tax-payers contribute money out of their pockets to the coal industry at the rate of 2s. per ton. It means that more coal is being mined than is really needed, and that the community is paying the producers to mine it and the consumer to buy it. It means that the coal-owner and the miner are being granted the right to continue mining coal at a time when there is no economic justification for their doing so. It puts a premium upon inefficiency, for so long as a subsidy can be had, there is no incentive to reduce production costs by more efficient methods of working or by amalgamation and rationalisation. Worse still, a subsidy must be granted impartially. In our example, a uniform production cost of 21s. is assumed all over the country. In practice the 21s. would be an average; some mines would be working at costs as low as the selling price of 19s., and to them the subsidy would be pure profit.

Thus there are many weighty reasons against granting subsidies to particular industries, even if the only alternative is the extinction of the home industry and reliance solely upon imports from abroad. Against these, however, one or two arguments can be adduced. The first is, if the law of the land imposes on the industry certain conditions such

as limited working hours or a minimum wage, or even high taxation of a kind that directly affects production costs, then those engaged in the industry have a claim against the State. Even so, the State has the right to reply that it is in the national interest that the industry should wholly or partially cease to exist. The next is that a subsidy may be justified as a temporary expedient, until such time as demand revives or the industry can reorganise itself upon a more profitable basis. Here the danger is lest the deadening effect of the subsidy may be to turn "temporary" into "permanent". Finally, the extinction of an important national industry involves the whole state in a definite measure of loss, and this must be set against the cost of the subsidy. Still, if judgment had to be delivered on this question, it would probably be that (a) a subsidy should only be granted sparingly and as a last resort; (b) that it must do no more than cover production costs, including possibly the normal rate of interest upon the capital corresponding to the real assets of each undertaking, but leaving no margin of profit in any way akin to a rent element; (c) that the extinction of the industry is overwhelmingly against the national advantage; and (d) that the State must take power to insist that the industry shall be transformed so as to be conducted upon the most efficient basis.

Direct subsidies to particular industries are granted comparatively rarely, and assistance given by the State usually takes an indirect form. Thus where the State owns the railways of the country, it may grant special rates to goods of a particular kind, or even to trade of a particular kind, as, for example, export trade. Even in England, where the railways are privately owned, the de-rating scheme of 1928 laid down that railways should not retain their share of the benefit of the scheme, but should pass it on to certain classes of users in the shape of reduced rates.

CHAPTER XLIX

Protection—Tariffs—Protection as a form of subsidy—Four disadvantages—The case for protection—Some fallacies—Effect of subsidies and protection on balance of payments—Some consequences thereof—Evils of trade restrictions—Tariff wars and agreements—England's position.

THE most common form of indirect State assistance to industries is that of protective tariffs. The chapter on national finance contained a brief reference to customs duties, and it was there stated that customs duties imposed on goods imported from abroad were not always balanced by excise duties upon similar goods made at home. Under a system of Protection, no excise duties at all are imposed, and the customs duties are imposed not only with the object of raising revenue, but also with the object of making the foreign goods more expensive than they otherwise would have been, and so giving the home manufacturer an advantage. Under the system of Free Trade, customs duties are imposed solely for revenue purposes and are balanced by equivalent excise duties.

The tariff is the name given to the schedule of customs duties imposed by a State. Protection is the proper name for the system, but in England, owing to the traditional national repugnance to the word Protection, which recalls memories of the Corn Laws and of the "hungry forties", certain protective duties imposed after the war were officially called "safeguarding" duties. The difference in meaning is not very clear.

Protection against foreign competition is clearly a form

of subsidy to the home producer. There is fundamentally no difference between giving money, on the one hand, to A at home and denying it to his competitor B abroad; and, on the other hand, in letting A's products go free and taxing B's products on entry into the country. Compared with a direct subsidy, protection has four great disadvantages. The first is that it is of no use to industries such as the cotton trade, who already have the home market to themselves and who only need bigger markets abroad. The next is that whereas the cost of a subsidy comes out of the national revenue and so is shared impartially among all tax-payers alike, the burden of a protective duty is laid solely upon those who preferred to buy the taxed foreign article instead of the protected home article; and as the reason for their preference was usually that the foreign article was cheaper, protective duties are peculiarly liable to fall upon those who have to sacrifice quality to cheapness, namely, upon the poorer sections of the community. The third objection is that whereas the size of a subsidy is known, no one can tell the exact magnitude of the assistance given to an industry by protection or the weight of the burden protection imposes upon the community. Finally, the object of a subsidy is, all said and done, to bring home prices down to the world-level. The object of protection is to bring the price of foreign goods up to the home-level.

In favour of protection as opposed to direct subsidies, the following can be said. The community are much more likely to accept a scheme which ostensibly brings them in revenue and whose real burden is concealed than one which imposes a direct and obvious burden upon the tax-payer for the benefit of a particular industry. More important still, it cannot be assumed at once that protection does raise prices, but this assertion has to be proved. The reason is that it is alleged that if home manufacturers get the home market to themselves, they can increase their sales and output, and so reduce their costs and prices. In fact, it is argued that even

if protection makes foreign goods dearer, it makes home goods cheaper, and so that on the average prices may not be raised. If this is so, no fresh burden is imposed upon the community at all, while in return, a fresh source of revenue has been found, an important home industry has been saved from extinction, and the workers in that industry have been kept in employment and saved from becoming a burden to the State.

Some readers may object that all this sounds too good to be true, and to a large extent it is. The first fallacy in this train of reasoning is that unless the home industry rationalises itself when it receives protection, the whole argument that freedom from competition will permit of larger sales and cheaper costs will fall to the ground, simply because of new competition at home. The post-war motor flotations (following the McKenna duties on foreign motors) and the 1928 film flotations (following the Act of Parliament forcing British cinemas to show a certain proportion of British films) are examples of this. The second is that if it be once granted that the prices of the cheaper classes of goods are raised, it does not lessen the burden if the prices of the dearer classes are reduced.

In any case, it seems clear that before an industry can qualify for protection, it must at least have been rationalised so as to operate with the greatest efficiency and at the lowest possible cost. In fact, the four conditions laid down for a direct subsidy apply equally to protection.

So far subsidies and protection have been discussed mainly from the standpoint of the industries they benefit. It remains to consider their effect upon the country as a whole. Now the chapter on the foreign exchanges contained an exposition of a country's balance of trade, and it was there shown that unless a country's payments to foreign nations balanced the receipts, certain consequences followed which affected first the money market and finally the general trade of the country.

A subsidy is intended to enable a home industry to hold its own with its foreign competitors in the world's markets, both at home and abroad. That means that if successful it will reduce imports of the particular commodity produced by the subsidised industry and will expand exports. Protection, too, is designed to prevent imports of a particular commodity, and some of its advocates even claim that if the home market is protected, exports will thereby be stimulated. In short, both policies alike should result in a reduction in imports, and so in the payments a country has to make abroad. They should also mean an increase in the exports of the subsidised and possibly of the protected commodity, and so an increase in the payments received from abroad in respect of that particular commodity. Both these changes mean that the balance of payments becomes more in favour of the country granting a subsidy or imposing a protective tariff.

This has two alternative consequences. Either compensating changes must occur in one or more of the other items comprised in the balance of payments or else the foreign exchanges will move against other countries, and eventually there will be an influx of gold. The compensating changes required are of the following character: (*a*) A shrinkage in the country's exports of other commodities, or in the services it renders to other countries; or (*b*) an increase in the net total of its capital invested abroad, due to such capital movements as an increase in new capital issues on behalf of foreign nations, the purchase of foreign stocks and shares or the sale by foreigners of the country's stocks and shares. It is also the case that certain of these compensating changes will follow from the alternative of an influx of gold. For if other countries lose gold, their trade will be restricted, their price-levels lowered and their interest rates forced up. Hence they will be unable to import as much as before, and they will be more inclined to borrow from the country that has received the gold, and where interest rates will there-

fore have remained low. Furthermore, the influx of gold will tend to raise prices in the country receiving it, which will again handicap its export trade.

Hence even if the subsidised or protected industry benefits, the export industries as a whole will suffer, and there will be a general drain of capital from the country. These consequences are clearly such as to promote an increase in unemployment generally, and it is this that is the fatal objection to the adoption of subsidies or protection as a remedy for unemployment. It is an objection that is particularly true of protection as a remedy for unemployment in Great Britain to-day, simply because unemployment is most serious in the export industries, such as coal and cotton, and in those industries such as building, which need an ample supply of capital if they are to prosper.

There is an additional argument of a general character against these policies. It is that the volume of business and, therefore, of employment is greatest when trade is unrestricted over the widest possible area. The business prosperity of the United States is due largely to the absence of tariffs or other restrictions upon trade between the various states, and the appearance of new nations in Europe since the war, each with its own new frontier and new tariff wall, is by common consent, as shown at the Geneva Conference held in 1927, one of the main causes of the post-war trade depression in Europe. Even the advocates of "Empire Free Trade", or the abolition of tariffs between England, the Dominions and the Colonies, recognise the value to trade of a large Free Trade area, though part of their policy consists of the institution of tariffs between the Empire (including England) and other countries, a proposal which would add to the present-day restrictions upon world trade.

It is often said that all this argument falls to the ground, because, for good or for evil, most other nations have adopted protection, and it is added that the only way to force down foreign tariffs is to set up one ourselves. This view is on the

whole fallacious. History shows that tariffs provoke tariffs, and that even a tariff wall that is initially a low one, grows higher rather than lower with each revision. Moreover, England, by virtue of her Free Trade policy, enjoys at the hands of other nations what is known as "most-favoured nation" treatment. This means that every tariff concession that one foreign nation makes to a second, is made automatically to England as well. In other words, British goods have the right of entering foreign countries over the lowest part of their tariff walls. Were England to introduce protection, she would lose the benefit of this concession.

In short, there is grave reason for believing that to England especially, with her whole business life organised for trading with the world at large, protection would do far more harm than good. Subsidies and protection have only one justification, namely, to keep in being industries in which large numbers of workers and much capital are already employed, and from which they cannot escape. Even so, the fact that such industries are, in England, mainly export industries means that protection can avail little. Subsidies might help more, but when the many and grave objections to subsidies are weighed against the few arguments in their favour, the balance of national advantage lies heavily against them.

CHAPTER L

National development schemes—Arguments in favour—Practical difficulties—Some general causes of unemployment—The need for co-operation—No single cure for unemployment—The duties of the State and the individual—The need for humanity.

THE reader will have appreciated the fundamental objection to the policies outlined above as a cure for unemployment, namely, that they consist of the diversion and restriction of trade rather than the creation of fresh trade, of fresh production and fresh work. This is recognised by another school of thought, whose thesis, expressed in popular form, is that there is something inherently wrong if on the one hand men are out of work and on the other hand there is work waiting to be done. By "work waiting to be done" is meant development schemes, such as the building of fresh roads and railways, or the improvement of existing means of transport; the abolition of slums and overcrowded or insanitary houses, and their replacement by new houses of a minimum standard of comfort and decency, and in sufficient numbers to provide adequate accommodation for our present population; the development of electric power on a national scale; the drainage of water-logged land; and other work of a similar kind designed to increase the comfort, well-being and efficiency of the nation.

Put in this way, there is considerable force in this argument. The community to-day are having to help to support some million unemployed in idleness, who are levying toll upon the community and admittedly through no fault of their own, giving nothing in return. Again, every fresh man

out of work reduces the consumptive power of the nation, and so means less demand for the products of our industries, and less work for others. Moreover, development schemes of this kind must necessarily be undertaken by the State. In many cases compulsory powers are required for the acquisition of land and the over-riding of local and private interests, and this alone involves State action. Furthermore, many of the schemes described above will yield no direct or immediate return on the capital required to be invested in them, but only a return to the community as a whole. The roads are free to all, and were a private company to obtain powers to build new roads, they could not levy tolls. Railway companies, it is true, will benefit from improvements to their systems, but the fresh income they will obtain may not be equivalent to the capital expenditure involved, and at the best, new traffic takes time to develop. As regards housing, there are grave doubts if the low rents the poorer sections of the community, who alone need re-housing, can afford are equivalent to the capital cost of building adequate houses.

This, broadly speaking, is the case in favour of national development schemes as a remedy for unemployment, but experience is showing that to put such schemes into practice is an extremely difficult matter, and we still have to consider whether or not their execution might not cause more unemployment than it would cure. To begin with, whether the work is undertaken by the community or by a private company, it entails the raising of capital, and while there is no hard and fast limit to the amount of capital in existence, a bold and comprehensive development policy might mean that some capital was diverted from other purposes where it would have provided employment. If part of the money is raised by taxation, it deprives the tax-payer of money which he could otherwise have spent or saved and invested, thereby providing employment, and in addition an increase in taxation has, as shown, a deadening effect upon trade. Again, the problem of the immobility and inelasticity of

the average worker still remains. There is some force in the argument against this policy that the true cure for unemployment is to get people back to work in their own trades and in their own localities rather than to set them to work on national schemes elsewhere.

The chief argument in favour of national development schemes is that they mean that the community will gain fresh assets that it would not otherwise have had. The gain, however, is not a clear one, for, as shown above, there is the danger that certain disadvantages will arise. Whether or not the experiment is worth trying is a matter that an impartial book of this kind has hardly the right to decide. The experience of other countries is some guide, though not a conclusive one. Possibly British economic history of the next few years will give a more definite answer to the question.

In any case, national development schemes cannot be a permanent substitute for an inadequate volume of trade and employment, and their value lies as much in the additions they may make to the efficiency and well-being of the nation as in the amount of temporary work their actual execution involves. Probably there is no single cure for unemployment, but the solution of the problem rests partly with the State and partly with the individual, whether capitalist, manager or worker. And the key to the problem is probably freedom, efficiency, and the maximum of output for the minimum of effort. The accountant will translate this last sentence into his dictum that the paramount need of British industry is to reduce its working costs at least to the general world-level. And he is right. The nation is in just the same position as any individual trading concern. Unless it can produce and sell as cheaply as its competitors, it is going to be forced out of business.

The government's share in the task of reducing costs is a limited one. It is confined to reducing the burden of taxation as far as is practicable and to apportioning that burden as

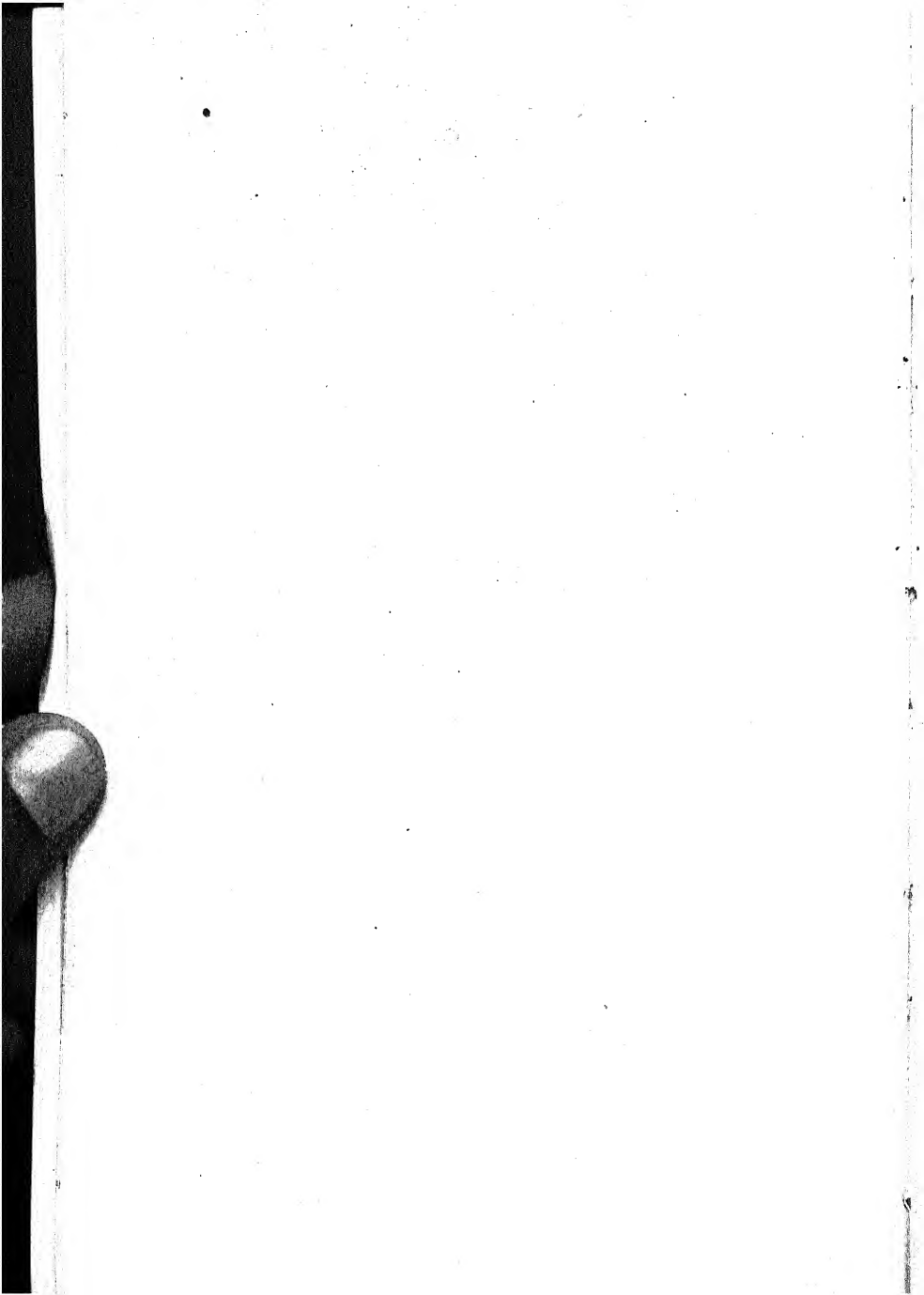
fairly as it can. Industry, and the profits of industry, of course, must bear their share, and income tax, which all trading concerns are liable to pay, is, strictly speaking, not part of the cost of production at all. On the other hand, if a business is to prosper, it must, as we have seen, allocate each year part of its profits to reserve, that is to financing further developments. The fact that income tax is levied on profits, even when they are devoted to reserve, may be one cause of the present stagnation of trade.

It might be worth investigating the question of whether the income tax on company profits could not be graduated. The first portion of profits, which ought to be, and under the scheme would have to be by law placed to reserve, might be exempt from tax. The second portion, corresponding to the normal interest on the invested capital, could be taxed fairly at the standard rate. All surplus profits, corresponding to some form of "rent", could be subjected to a graduated surtax. The practical difficulties of such a scheme, and the possibilities of fraud and evasion, are admittedly enormous, and so it is only mooted in a very tentative and general way.

Still, all said and done, the responsibility for the solution of the unemployment problem rests mainly with individuals themselves. This is the day of the large business, and whether or not we like it, we must come into line. Rationalisation is not a task to be undertaken rashly or light-heartedly. It must be free from any element of restriction or price-fixing, and must be undertaken solely to promote efficiency and to reduce costs and not to create scarcity or to raise prices, or to put money into financiers' pockets. The active co-operation of all engaged in industry must be sought and won, and it must be realised that the promotion of humanity in industrial relations is one of the surest roads to efficiency that there is. Humanity means essentially a fair share and a fair voice for all, and fair play between all the partners in industry must be the objective.

The science of economics, as discussed in this book, may

in places, seem to be dry and soulless, and to consist of a set of rules according to which each of us plays his own selfish game. In one sense this is true, for the more a man can get, the more he can and will be prepared to give. Yet the nation, the factory and the business that has a soul and which realises the need for humanity and co-operation, will win in the long run every time. The economist may have to give most of his time to laying down the rules of the game of life. He must never forget to insist that what really matters is the spirit in which the game is played.



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